File No. PCAOB 2010-01
Consists of 1901 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 19b-4

Proposed Rules

By

Public Company Accounting Oversight Board

In accordance with Rule 19b-4 under the
Securities Exchange Act of 1934

1. <u>Text of the Proposed Rules</u>

(a) Pursuant to the provisions of Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") is filing with the Securities and Exchange Commission ("SEC" or "Commission") proposed rules composed of the following eight auditing standards:

- Auditing Standard No. 8, *Audit Risk*
- Auditing Standard No. 9, *Audit Planning*
- Auditing Standard No. 10, *Supervision of the Audit Engagement*
- Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*
- Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*
- Auditing Standard No. 14, *Evaluating Audit Results*
- Auditing Standard No. 15, *Audit Evidence*

(collectively referred to as the "Risk Assessment Standards"); and amendment to the Board's interim auditing standards. The proposed rules are attached as Exhibit A to this rule filing.

(b) The Risk Assessment Standards will supersede the following sections of the Board's interim auditing standards:

- AU sec. 311, *Planning and Supervision*
- AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*

- AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date*
- AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*
- AU sec. 326, *Evidential Matter*
- AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

(c) Not applicable.

2. Procedures of the Board

(a) The Board approved the proposed rules, and authorized them for filing with the SEC, at its Open Meeting on August 5, 2010. No other action by the Board is necessary for the filing of the proposed rules.

(b) Questions regarding this rule filing may be directed to Keith Wilson, Deputy Chief Auditor (202/207-9134, wilsonk@pcaobus.org), Jessica Watts, Associate Chief Auditor (202/207-9376, wattsj@pcaobus.org), Hasnat Ahmad, Assistant Chief Auditor (202/207-9349, ahmadh@pcaobus.org), Diane Jules, Assistant Chief Auditor (202/207-9111, julesd@pcaobus.org), and Hong Zhao, Assistant Chief Auditor (202/207-9355, zhaoh@pcaobus.org). Robert E. Burns, Associate General Counsel (202-207-9153, burnsr@pcaobus.org), or Nina Mojiri-Azad, Assistant General Counsel (202-207-9035; mojiriazadn@pcaobus.org).

3. Board's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rules Change

(a) Purpose

Section 103(a) of the Act directs the Board, by rule, to establish, among other things, "auditing and related attestation standards . . . to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by th[e] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." As discussed more fully in Exhibit 3, the Board adopted eight auditing standards and related amendments that benefit investors by establishing requirements that enhance the effectiveness of the auditor's assessment of and response to the risks of material misstatement in an audit.

In an audit performed in accordance with PCAOB standards, risk underlies the entire audit process, including the procedures that the auditor performs to support the opinion expressed in the auditor's report. Most of the Board's interim auditing standards relating to assessing and responding to risk in an audit of financial statements were developed in the 1980s.[1/] Those standards described in general terms the auditor's responsibilities for assessing and responding to risk. They directed auditors to vary the amount of audit attention related to particular financial statement accounts based on the risks presented by them. The standards also allowed the auditor to use tests of controls to reduce substantive testing.[2/]

A number of factors and events led the Board to reexamine those standards and seek to improve them. These included the widespread use of risk-based audit methodologies; recommendations to the profession on ways in which

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1/ Examples of those standards include AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, and AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit.*

2/ AU sec. 319.

auditors could improve risk assessment;[3/] advice from the Board's Standing Advisory Group ("SAG");[4/] adoption of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*; and observations from the Board's oversight activities.

On October 21, 2008, the Board proposed a set of auditing standards to update the requirements for assessing and responding to risk in an audit ("the original proposed standards").[5/] The original proposed standards were intended to improve the auditing standards and to benefit investors by establishing requirements that enhance the effectiveness of auditors' assessment of and response to risk through:

- Performing procedures that provide a reasonable basis for identifying and assessing risks of material misstatement, whether due to error or fraud

- Tailoring the audit to respond appropriately to the risks of material misstatement

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[3/] See, e.g., Public Oversight Board, Panel on Audit Effectiveness ("PAE"), *Report and Recommendations* (August 31, 2000). For a summary of the PAE's recommendations related to risk assessment, see PCAOB Standing Advisory Group ("SAG") Meeting Briefing Paper, "Risk Assessment in Financial Statement Audits" (February 16, 2005), Appendix A, available at: http://www.pcaobus.org/News_and_Events/Events/2005/02-16.aspx.

[4/] Webcasts of SAG meetings are available on the Board's Web site at: http://www.pcaobus.org/News_and_Events/Webcasts.

[5/] PCAOB Release No. 2008-006, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (October 21, 2008).

- Making a comprehensive evaluation of the evidence obtained during the audit to form the opinion(s) in the auditor's report

The Board also sought to emphasize the auditor's responsibilities for consideration of fraud by incorporating requirements for identifying and responding to the risks of material misstatement due to fraud ("fraud risks") and evaluating audit results from the existing PCAOB standard, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*[6/] Incorporating these requirements makes clear that the auditor's responsibilities for assessing and responding to fraud risks are an integral part of the audit process rather than a separate, parallel process. It also benefits investors by prompting auditors to make a more thoughtful and thorough assessment of fraud risks and to develop appropriate audit responses.

Improvements in the standards related to risk assessment also should enhance integration of the audit of financial statements with the audit of internal control over financial reporting ("audit of internal control") by articulating a process for identifying and assessing risks of material misstatement that applies to both portions of the integrated audit when the auditor is performing an integrated audit.

The proposed rules also amend the Board's interim standards including superseding the following sections of PCAOB interim auditing standards:

[6/] Paragraphs .14-.51 and paragraphs .68-.78 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

- AU sec. 311, *Planning and Supervision*
- AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*
- AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date*
- AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*
- AU sec. 326, *Evidential Matter*
- AU sec. 431, *Adequacy of Disclosure in Financial Statements*

Similarly, the auditing interpretations of AU secs. 311, 312, and 350 have been incorporated into the risk assessment standards and thus are superseded. The auditing interpretations of AU sec. 326, except for Interpretation No. 2 (AU secs. 9326.06-.23), also are superseded.[7/]

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

4. Board's Statement on Burden on Competition

The Board does not believe that the proposed rules will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rule changes would apply equally to all registered public accounting firms conducting audits in accordance with PCAOB standards.

[7/] Interpretation No. 2 relates in part to AU sec. 336 and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments,* and it will be evaluated in connection with standards-setting projects related to those standards.

5. Board's Statement on Comments on the Proposed Rules Change Received from Members, Participants or Others

The Board initially released the proposed rules for public comment on October 21, 2008. See Exhibit 2(a)(A). The Board received 33 written comment letters relating to its initial proposed rules. See Exhibits 2(a)(B) and 2(a)(C). The Board considered these comments and made changes to the initial proposed rules. As a result, the Board again sought public comment on the proposed rules on December 17, 2009. See Exhibit 2(a)(D). The Board received 23 written comment letters relating to its reproposal of the proposed rules. See Exhibits 2(a)(E) and 2(a)(F).

The Board has carefully considered all comments it has received. In response to the written comments received on both the initial and reproposal of the proposed rules, the Board has clarified and modified certain aspects of the proposed rules. The Board's response to the comments it received and the changes made to the rules in response to the comments received are summarized in Exhibits 2(a)(D) and 3 to this filing.

6. Extension of Time Period for Commission Action

The Board does not consent to an extension of the time period specified in Section 19(b)(2) of the Securities Exchange Act of 1934.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rules Based on Rules of Another Board or of the Commission

Not applicable.

9. Exhibits

Exhibit A –	Text of the Proposed Rules
Exhibit 1 –	Form of Notice of Proposed Rules for Publication in the Federal Register.
Exhibit 2(a)(A) –	PCAOB Release No. 2008-006 (October 21, 2008)
Exhibit 2(a)(B) –	Alphabetical List of Comments on the rules proposed in PCAOB Release No 2008-006
Exhibit 2(a)(C) –	Written comments on the rules proposed in PCAOB Release No. 2008-006
Exhibit 2(a)(D) –	PCAOB Release No. 2009-007 (December 17, 2009)
Exhibit 2(a)(E) –	Alphabetical List of Comments on the rules proposed in PCAOB Release No 2009-007
Exhibit 2(a)(F) –	Written comments on the rules proposed in PCAOB Release No. 2009-007
Exhibit 2(b)	Transcript of portion of April 8, 2010 Public Standing Advisory Group meeting concerning the proposed rule change
Exhibit 3 –	PCAOB Release No. 2010-004 (August 5, 2010)

10. Signatures

Pursuant to the requirements of the Act and the Securities Exchange Act of 1934, as amended, the Board has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Public Company Accounting Oversight Board

By: ______________________
J. Gordon Seymour
General Counsel
and Secretary

September 14, 2010

Exhibit A – Text of the Proposed Rules

Below are the Risk Assessments Standards and amendment to the Board's interim auditing standards.

Auditing Standard No. 8

Audit Risk

Introduction

1. This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit[1/] or an audit of financial statements only.

Objective

2. The objective of the auditor is to conduct the audit of financial statements in a manner that reduces audit risk to an appropriately low level.

Audit Risk

3. To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement[2/] due to error or fraud. Reasonable assurance[3/] is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.

[1/] When the auditor is performing an integrated audit of financial statements and internal control over financial reporting, the requirements in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* also apply. However, the risks of material misstatement of the financial statements are the same for both the audit of financial statements and the audit of internal control over financial reporting.

[2/] Misstatement is defined in Appendix A of Auditing Standard No. 14, *Evaluating Audit Results*.

[3/] See AU sec. 110, *Responsibilities and Functions of the Independent Auditor,* and paragraph .10 of AU sec. 230, *Due Professional Care in the Performance of Work,* for a further discussion of reasonable assurance.

4. In an audit of financial statements, audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial reporting framework. Audit risk is a function of the risk of material misstatement and detection risk.

> Note: The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

Risk of Material Misstatement

5. The risk of material misstatement refers to the risk that the financial statements are materially misstated. Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* indicates that the auditor should assess the risks of material misstatement at two levels: (1) at the financial statement level and (2) at the assertion[4/] level.[5/]

6. Risks of material misstatement at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of material misstatement at the financial statement level may be especially relevant to the auditor's consideration of the risk of material misstatement due to fraud. For example, an ineffective control environment, a lack of sufficient capital to continue operations, and declining conditions affecting the company's industry might create pressures or opportunities for management to manipulate the financial statements, leading to higher risk of material misstatement.

7. Risk of material misstatement at the assertion level consists of the following components:

a. *Inherent risk,* which refers to the susceptibility of an assertion to a misstatement, due to error or fraud, that could be material, individually or in combination with other misstatements, before consideration of any related controls.

b. *Control risk,* which is the risk that a misstatement due to error or fraud that could occur in an assertion and that could be material,

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4/ See Auditing Standard No. 15, *Audit Evidence,* for a description of financial statement assertions.

5/ Paragraph 59 of Auditing Standard No. 12.

individually or in combination with other misstatements, will not be prevented or detected on a timely basis by the company's internal control. Control risk is a function of the effectiveness of the design and operation of internal control.

8. Inherent risk and control risk are related to the company, its environment, and its internal control, and the auditor assesses those risks based on evidence he or she obtains. The auditor assesses inherent risk using information obtained from performing risk assessment procedures and considering the characteristics of the accounts and disclosures in the financial statements.[6/] The auditor assesses control risk using evidence obtained from tests of controls (if the auditor plans to rely on those controls to assess control risk at less than maximum) and from other sources.[7/]

Detection Risk

9. In an audit of financial statements, detection risk is the risk that the procedures performed by the auditor will not detect a misstatement that exists and that could be material, individually or in combination with other misstatements. Detection risk is affected by (1) the effectiveness of the substantive procedures and (2) their application by the auditor, i.e., whether the procedures were performed with due professional care.

10. The auditor uses the assessed risk of material misstatement to determine the appropriate level of detection risk for a financial statement assertion. The higher the risk of material misstatement, the lower the level of detection risk needs to be in order to reduce audit risk to an appropriately low level.

11. The auditor reduces the level of detection risk through the nature, timing, and extent of the substantive procedures performed. As the appropriate level of detection risk decreases, the evidence from substantive procedures that the auditor should obtain increases.[8/]

[6/] Paragraph 59.a. of Auditing Standard No. 12.

[7/] Paragraphs 32-34 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

[8/] Paragraph 37 of Auditing Standard No. 13.

Auditing Standard No. 9

Audit Planning

Introduction

1. This standard establishes requirements regarding planning an audit.

Objective

2. The objective of the auditor is to plan the audit so that the audit is conducted effectively.

Responsibility of the Engagement Partner for Planning

3. The **engagement partner**[1/] is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for planning the audit and may seek assistance from appropriate engagement team members in fulfilling this responsibility. Engagement team members who assist the engagement partner with audit planning also should comply with the relevant requirements in this standard.

Planning an Audit

4. The auditor should properly plan the audit. This standard describes the auditor's responsibilities for properly planning the audit.[2/]

5. Planning the audit includes establishing the overall audit strategy for the engagement and developing an audit plan, which includes, in particular, planned risk assessment procedures and planned responses to the risks of material misstatement. Planning is not a discrete phase of an audit but, rather, a continual and iterative process that might begin shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit.

[1/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

[2/] The term, "auditor," as used in this standard, encompasses both the engagement partner and the engagement team members who assist the engagement partner in planning the audit.

Preliminary Engagement Activities

6. The auditor should perform the following activities at the beginning of the audit:

a. Perform procedures regarding the continuance of the client relationship and the specific audit engagement,[3/]

b. Determine compliance with independence and ethics requirements, and

> Note: The determination of compliance with independence and ethics requirements is not limited to preliminary engagement activities and should be reevaluated with changes in circumstances.

c. Establish an understanding with the client regarding the services to be performed on the engagement.[4/]

Planning Activities

7. The nature and extent of planning activities that are necessary depend on the size and complexity of the company, the auditor's previous experience with the company, and changes in circumstances that occur during the audit. When developing the audit strategy and audit plan, as discussed in paragraphs 8-10, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures:

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;

- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;

- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;

[3/] Paragraphs .14-.16 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice.* AU sec. 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards,* explains how the quality control standards relate to the conduct of audits.

[4/] AU sec. 310, *Appointment of the Independent Auditor.*

- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality,[5/] risk, and, in integrated audits, other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee[6/] or management;
- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;
- Preliminary judgments about the effectiveness of internal control over financial reporting;
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;
- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and
- The relative complexity of the company's operations.

  Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in

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[5/] Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit.*

[6/] If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

Audit Strategy

8. The auditor should establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan.

9. In establishing the overall audit strategy, the auditor should take into account:

a. The reporting objectives of the engagement and the nature of the communications required by PCAOB standards,[7/]

b. The factors that are significant in directing the activities of the engagement team,[8/]

c. The results of preliminary engagement activities[9/] and the auditor's evaluation of the important matters in accordance with paragraph 7 of this standard, and

d. The nature, timing, and extent of resources necessary to perform the engagement.[10/]

Audit Plan

10. The auditor should develop and document an audit plan that includes a description of:

[7/] See, e.g., AU sec. 310 and AU sec. 380, *Communication With Audit Committees.* Also, various laws or regulations require other matters to be communicated. (See, e.g., Rule 2-07 of Regulation S-X, 17 CFR 210.2-07; and Rule 10A-3 under the Securities Exchange Act of 1934, 17 CFR 240.10A-3.) The requirements of this standard do not modify communications required by those other laws or regulations.

[8/] See, e.g., paragraph 6 of Auditing Standard No. 10, *Supervision of the Audit Engagement*.

[9/] Paragraph 6 of this standard.

[10/] See, e.g., paragraph .06 of AU sec. 230, *Due Professional Care in the Performance of Work,* paragraph 16 of this standard, and paragraph 5.a. of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

a. The planned nature, timing, and extent of the risk assessment procedures;[11]

b. The planned nature, timing, and extent of tests of controls and substantive procedures;[12] and

c. Other planned audit procedures required to be performed so that the engagement complies with PCAOB standards.

Multi-location Engagements

11. In an audit of the financial statements of a company with operations in multiple locations or business units,[13] the auditor should determine the extent to which audit procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual locations or business units. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit.

12. Factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures include:

a. The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including, e.g., significant transactions executed at the location or business unit that are outside the normal course of business for the company, or that

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11/ Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

12/ Auditing Standard No. 13 and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

13/ The term "business units" includes subsidiaries, divisions, branches, components, or investments.

otherwise appear to be unusual given the auditor's understanding of the company and its environment;[14/]

b. The materiality of the location or business unit;[15/]

c. The specific risks associated with the location or business unit that present a reasonable possibility[16/] of material misstatement to the company's consolidated financial statements;

d. Whether the risks of material misstatement associated with the location or business unit apply to other locations or business units such that, in combination, they present a reasonable possibility of material misstatement to the company's consolidated financial statements;

e. The degree of centralization of records or information processing;

f. The effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or business unit; and

g. The frequency, timing, and scope of monitoring activities by the company or others at the location or business unit.

> Note: When performing an audit of internal control over financial reporting, refer to Appendix B, Special Topics, of Auditing Standard No. 5[17/] for considerations when a company has multiple locations or business units.

[14/] Paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*

[15/] Paragraph 10 of Auditing Standard No. 11 describes the consideration of materiality in planning and performing audit procedures at an individual location or business unit.

[16/] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

[17/] Paragraphs B10-B16 of Auditing Standard No. 5.

13. In determining the locations or business units at which to perform audit procedures, the auditor may take into account relevant activities performed by internal audit, as described in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* or others, as described in Auditing Standard No. 5. AU sec. 322 and Auditing Standard No. 5 establish requirements regarding using the work of internal audit and others, respectively.

14. AU sec. 543, *Part of Audit Performed by Other Independent Auditors,* describes the auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or more of the locations or business units that are included in the consolidated financial statements.[18/] In those situations, the auditor should perform the procedures in paragraphs 11-13 of this standard to determine the locations or business units at which audit procedures should be performed.

Changes During the Course of the Audit

15. The auditor should modify the overall audit strategy and the audit plan as necessary if circumstances change significantly during the course of the audit, including changes due to a revised assessment of the risks of material misstatement or the discovery of a previously unidentified risk of material misstatement.

Persons with Specialized Skill or Knowledge

16. The auditor should determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

17. If a person with specialized skill or knowledge employed or engaged by the auditor participates in the audit, the auditor should have sufficient knowledge of the subject matter to be addressed by such a person to enable the auditor to:

a. Communicate the objectives of that person's work;

b. Determine whether that person's procedures meet the auditor's objectives; and

c. Evaluate the results of that person's procedures as they relate to the nature, timing, and extent of other planned audit procedures and the effects on the auditor's report.

[18/] For integrated audits, see also paragraphs C8-C11 of Auditing Standard No. 5.

Additional Considerations in Initial Audits

18. The auditor should undertake the following activities before starting an initial audit:

a. Perform procedures regarding the acceptance of the client relationship and the specific audit engagement; and

b. Communicate with the predecessor auditor in situations in which there has been a change of auditors in accordance with AU sec. 315, *Communications Between Predecessor and Successor Auditors.*

19. The purpose and objective of planning the audit are the same for an initial audit or a recurring audit engagement. However, for an initial audit, the auditor should determine the additional planning activities necessary to establish an appropriate audit strategy and audit plan, including determining the audit procedures necessary to obtain sufficient appropriate audit evidence regarding the opening balances.[19/]

[19/] See also paragraph 3 of Auditing Standard No. 6, *Evaluating Consistency of Financial Statements.*

APPENDIX A − Definition

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Engagement partner – The member of the engagement team with primary responsibility for the audit.

Auditing Standard No. 10

Supervision of the Audit Engagement

Introduction

1. This standard establishes requirements regarding supervision of the audit engagement, including supervising the work of engagement team members.

Objective

2. The objective of the auditor is to supervise the audit engagement, including supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

Responsibility of the Engagement Partner for Supervision

3. The **engagement partner**[1/] is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for proper supervision of the work of engagement team members and for compliance with PCAOB standards, including standards regarding using the work of specialists,[2/] other auditors,[3/] internal auditors,[4/] and others who are involved in testing controls.[5/] Paragraphs 5-6 of this standard describe the nature and extent of supervisory activities necessary for proper supervision of engagement team members.[6/]

1/ Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

2/ AU sec. 336, *Using the Work of a Specialist.*

3/ AU sec. 543, *Part of Audit Performed by Other Independent Auditors.*

4/ AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.*

5/ Paragraphs 16-19 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

6/ See also paragraph .06 of AU sec. 230, *Due Professional Care in the Performance of Work.*

4. The engagement partner may seek assistance from appropriate engagement team members in fulfilling his or her responsibilities pursuant to this standard. Engagement team members who assist the engagement partner with supervision of the work of other engagement team members also should comply with the requirements in this standard with respect to the supervisory responsibilities assigned to them.

Supervision of Engagement Team Members

5. The engagement partner and, as applicable, other engagement team members performing supervisory activities, should:

a. Inform engagement team members of their responsibilities,[7/] including:

   (1) The objectives of the procedures that they are to perform;

   (2) The nature, timing, and extent of procedures they are to perform; and

   (3) Matters that could affect the procedures to be performed or the evaluation of the results of those procedures, including relevant aspects of the company, its environment, and its internal control over financial reporting,[8/] and possible accounting and auditing issues;

b. Direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities so they can evaluate those issues

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[7/] AU sec. 230.06 and paragraph 5 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement,* establish requirements regarding the appropriate assignment of engagement team members.

[8/] Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* describes the auditor's responsibilities for obtaining an understanding of the company, its environment, and its internal control over financial reporting.

and determine that appropriate actions are taken in accordance with PCAOB standards;[9]

> Note: In applying due professional care in accordance with AU sec. 230, each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or the auditor's report regardless of how those disagreements or concerns may have arisen.

c. Review the work of engagement team members to evaluate whether:

(1) The work was performed and documented;

(2) The objectives of the procedures were achieved; and

(3) The results of the work support the conclusions reached.[10]

6. To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, the engagement partner and other engagement team members performing supervisory activities should take into account:

a. The nature of the company, including its size and complexity;[11]

b. The nature of the assigned work for each engagement team member, including:

(1) The procedures to be performed, and

(2) The controls or accounts and disclosures to be tested;

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[9] See, e.g., paragraph 15 of Auditing Standard No. 9, *Audit Planning,* paragraph 74 of Auditing Standard No. 12, and paragraphs 20-23 and 35-36 of Auditing Standard No. 14, *Evaluating Audit Results.*

[10] Auditing Standard No. 14 describes the auditor's responsibilities for evaluating the results of the audit, and Auditing Standard No. 3, *Audit Documentation,* establishes requirements regarding audit documentation.

[11] Paragraph 10 of Auditing Standard No. 12.

c. The risks of material misstatement; and

d. The knowledge, skill, and ability of each engagement team member.[12]

> Note: In accordance with the requirements of paragraph 5 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, the extent of supervision of engagement team members should be commensurate with the risks of material misstatement.[13]

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[12] See also paragraph 5.a. of Auditing Standard No. 13 and AU sec. 230.06.

[13] Paragraph 5.b. of Auditing Standard No. 13 indicates that the extent of supervision of engagement team members is part of the auditor's overall responses to the risks of material misstatement.

APPENDIX A − Definition

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Engagement partner – The member of the engagement team with primary responsibility for the audit.

Auditing Standard No. 11

Consideration of Materiality in Planning and Performing an Audit

Introduction

1. This standard establishes requirements regarding the auditor's consideration of materiality in planning and performing an audit.[1/]

Materiality in the Context of an Audit

2. In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[2/] As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him …."[3/]

3. To obtain reasonable assurance about whether the financial statements are free of material misstatement, the auditor should plan and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements. This includes being alert while planning and performing audit procedures for misstatements that could be material due to quantitative or qualitative factors. Also, the evaluation of uncorrected misstatements in accordance with Auditing Standard No. 14, *Evaluating Audit Results,* requires consideration of both qualitative and quantitative factors.[4/] However, it ordinarily is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors.

4. For integrated audits, Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, states, "In planning the audit of internal control over financial

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[1/] Auditing Standard No. 14 establishes requirements regarding the auditor's consideration of materiality in evaluating audit results.

[2/] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

[3/] TSC Industries, 426 U.S. at 450.

[4/] Appendix B of Auditing Standard No. 14.

reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements."[5/]

Objective

5. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing audit procedures.

Considering Materiality in Planning and Performing an Audit

Establishing a Materiality Level for the Financial Statements as a Whole

6. To plan the nature, timing, and extent of audit procedures, the auditor should establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This includes consideration of the company's earnings and other relevant factors. To determine the nature, timing, and extent of audit procedures, the materiality level for the financial statements as a whole needs to be expressed as a specified amount.

> Note: If financial statements for the audit period are not available, the auditor may establish an initial materiality level based on estimated or preliminary financial statement amounts. In those situations, the auditor should take into account the effects of known or expected changes in the company's financial statements, including significant transactions or adjustments that are expected to be reflected in the financial statements at the end of the period.

Establishing Materiality Levels for Particular Accounts or Disclosures

7. The auditor should evaluate whether, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. If so, the auditor should establish separate materiality levels for those accounts or disclosures to plan the nature, timing, and extent of audit procedures for those accounts or disclosures.

> Note: Lesser amounts of misstatements could influence the judgment of a reasonable investor because of qualitative factors, e.g., because of the sensitivity of circumstances surrounding misstatements, such as conflicts of interest in related party transactions.

[5/] Paragraph 20 of Auditing Standard No. 5.

Determining Tolerable Misstatement

8. The auditor should determine the amount or amounts of tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level. The auditor should determine tolerable misstatement at an amount or amounts that reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the financial statements. Accordingly, tolerable misstatement should be less than the materiality level for the financial statements as a whole and, if applicable, the materiality level or levels for particular accounts or disclosures.

9. In determining tolerable misstatement and planning and performing audit procedures, the auditor should take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods.

Considerations for Multi-location Engagements

10. For purposes of the audit of the consolidated financial statements of a company with multiple locations or business units, the auditor should determine tolerable misstatement for the individual locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements. Accordingly, tolerable misstatement at an individual location should be less than the materiality level for the financial statements as a whole.

Considerations as the Audit Progresses

11. The auditor should reevaluate the established materiality level or levels and tolerable misstatement when, because of changes in the particular circumstances or additional information that comes to the auditor's attention, there is a substantial likelihood that misstatements of amounts that differ significantly from the materiality level or levels that were established initially would influence the judgment of a reasonable investor. Situations in which changes in circumstances or additional information that comes to the auditor's attention would require such reevaluation include:

a. The materiality level or levels and tolerable misstatement were established initially based on estimated or preliminary financial statement amounts that differ significantly from actual amounts.

b. Events or changes in conditions occurring after the materiality level or levels and tolerable misstatement were established initially are likely to affect investors' perceptions about the company's financial position, results of operations, or cash flows.

> Note: Examples of such events or changes in conditions include (1) changes in laws, regulations, or the applicable financial reporting framework that affect investors' expectations about the measurement or disclosure of certain items and (2) significant new contractual arrangements that draw attention to a particular aspect of a company's business that is separately disclosed in the financial statements.

12. If the auditor's reevaluation results in a lower amount for the materiality level or levels or tolerable misstatement than initially established by the auditor, the auditor should (1) evaluate the effect, if any, of the lower amount or amounts on his or her risk assessments and audit procedures and (2) modify the nature, timing, and extent of audit procedures as necessary to obtain sufficient appropriate audit evidence.

> Note: The reevaluation of the materiality level or levels and tolerable misstatement is also relevant to the auditor's evaluation of uncorrected misstatements in accordance with Auditing Standard No. 14.[6/]

[6/] Paragraph 17 of Auditing Standard No. 14.

Auditing Standard No. 12

Identifying and Assessing Risks of Material Misstatement

Introduction

1. This standard establishes requirements regarding the process of identifying and assessing risks of material misstatement[1/] of the financial statements.

2. Paragraphs 4-58 of this standard discuss the auditor's responsibilities for performing **risk assessment procedures**.[2/] Paragraphs 59-73 of this standard discuss identifying and assessing the risks of material misstatement using information obtained from performing risk assessment procedures.

Objective

3. The objective of the auditor is to identify and appropriately assess the risks of material misstatement, thereby providing a basis for designing and implementing responses to the risks of material misstatement.

Performing Risk Assessment Procedures

4. The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud,[3/] and designing further audit procedures.[4/]

5. Risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. For example, external or

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[1/] Paragraphs 5-8 of Auditing Standard No. 8, *Audit Risk*.

[2/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

[3/] AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, discusses fraud, its characteristics, and the types of misstatements due to fraud that are relevant to the audit, i.e., misstatements arising from fraudulent financial reporting and misstatements arising from asset misappropriation.

[4/] Auditing Standard No. 15, *Audit Evidence*, describes further audit procedures as consisting of tests of controls and substantive procedures.

company-specific factors can affect the judgments involved in determining accounting estimates or create pressures to manipulate the financial statements to achieve certain financial targets. Also, risks of material misstatement may relate to, e.g., personnel who lack the necessary financial reporting competencies, information systems that fail to accurately capture business transactions, or financial reporting processes that are not adequately aligned with the requirements in the applicable financial reporting framework. Thus, the audit procedures that are necessary to identify and appropriately assess the risks of material misstatement include consideration of both external factors and company-specific factors. This standard discusses the following risk assessment procedures:

a. Obtaining an understanding of the company and its environment (paragraphs 7-17);

b. Obtaining an understanding of internal control over financial reporting (paragraphs 18-40);

c. Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company (paragraphs 41-45);

d. Performing analytical procedures (paragraphs 46-48);

e. Conducting a discussion among engagement team members regarding the risks of material misstatement (paragraphs 49-53); and

f. Inquiring of the audit committee, management, and others within the company about the risks of material misstatement (paragraphs 54-58).

> Note: This standard describes an approach to identifying and assessing risks of material misstatement that begins at the financial statement level and with the auditor's overall understanding of the company and its environment and works down to the significant accounts and disclosures and their relevant assertions.[5/]

6. In an integrated audit, the risks of material misstatement of the financial statements are the same for both the audit of internal control over financial

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[5/] Paragraph 11 of Auditing Standard No. 15 discusses financial statement assertions.

reporting and the audit of financial statements. The auditor's risk assessment procedures should apply to both the audit of internal control over financial reporting and the audit of financial statements.

Obtaining an Understanding of the Company and Its Environment

7. The auditor should obtain an understanding of the company and its environment ("understanding of the company") to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. Obtaining an understanding of the company includes understanding:

a. Relevant industry, regulatory, and other external factors;

b. The nature of the company;

c. The company's selection and application of accounting principles, including related disclosures;

d. The **company's objectives and strategies** and those related **business risks** that might reasonably be expected to result in risks of material misstatement; and

e. The company's measurement and analysis of its financial performance.

8. In obtaining an understanding of the company, the auditor should evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.

Industry, Regulatory, and Other External Factors

9. Obtaining an understanding of relevant industry, regulatory, and other external factors encompasses industry factors, including the competitive environment and technological developments; the regulatory environment, including the applicable financial reporting framework[6/] and the legal and political environment;[7/] and external factors, including general economic conditions.

[6/] The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

[7/] AU sec. 317, *Illegal Acts by Clients*, discusses the auditor's consideration of laws and regulations relevant to the audit.

Nature of the Company

10. Obtaining an understanding of the nature of the company includes understanding:

- The company's organizational structure and management personnel;
- The sources of funding of the company's operations and investment activities, including the company's capital structure, noncapital funding (e.g., subordinated debt or dependencies on supplier financing), and other debt instruments;
- The company's significant investments, including equity method investments, joint ventures, and variable interest entities;
- The company's operating characteristics, including its size and complexity;

  Note: The size and complexity of a company might affect the risks of misstatement and how the company addresses those risks.

- The sources of the company's earnings, including the relative profitability of key products and services; and
- Key supplier and customer relationships.

  Note: The auditor should take into account the information gathered while obtaining an understanding of the nature of the company when determining the existence of related parties in accordance with AU sec. 334, *Related Parties.*

11. As part of obtaining an understanding of the company as required by paragraph 7, the auditor should consider performing the following procedures and the extent to which the procedures should be performed:

- Reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and, in an integrated audit, the effectiveness of the company's internal control over financial reporting, e.g., company-issued press releases, company-prepared presentation materials for analysts or investor groups, and analyst reports;
- Observing or reading transcripts of earnings calls and, to the extent publicly available, other meetings with investors or rating agencies;

- Obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses; and

- Obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders to identify potentially significant unusual developments (e.g., from Forms 3, 4, 5, 13D, and 13G).

Selection and Application of Accounting Principles, Including Related Disclosures

12. As part of obtaining an understanding of the company's selection and application of accounting principles, including related disclosures, the auditor should evaluate whether the company's selection and application of accounting principles are appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the relevant industry. Also, to identify and assess risks of material misstatement related to omitted, incomplete, or inaccurate disclosures, the auditor should develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.

13. The following matters, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles, including related disclosures:

- Significant changes in the company's accounting principles, financial reporting policies, or disclosures and the reasons for such changes;

- The financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles;

- The accounts or disclosures for which judgment is used in the application of significant accounting principles, especially in determining management's estimates and assumptions;

- The effect of significant accounting principles in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;

- The methods the company uses to account for significant and unusual transactions; and

- Financial reporting standards and laws and regulations that are new to the company, including when and how the company will adopt such requirements.

Company Objectives, Strategies, and Related Business Risks

14. The purpose of obtaining an understanding of the company's objectives, strategies, and related business risks is to identify business risks that could reasonably be expected to result in material misstatement of the financial statements.

> Note: Some relevant business risks might be identified through other risk assessment procedures, such as obtaining an understanding of the nature of the company and understanding industry, regulatory, and other external factors.

15. The following are examples of situations in which business risks might result in material misstatement of the financial statements:

- Industry developments (a potential related business risk might be, e.g., that the company does not have the personnel or expertise to deal with the changes in the industry.)

- New products and services (a potential related business risk might be, e.g., that the new product or service will not be successful.)

- Use of information technology ("IT") (a potential related business risk might be, e.g., that systems and processes are incompatible.)

- New accounting requirements (a potential related business risk might be, e.g., incomplete or improper implementation of a new accounting requirement.)

- Expansion of the business (a potential related business risk might be, e.g., that the demand for the company's products or services has not been accurately estimated.)

- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, e.g., incomplete or improper implementation of the strategy.)

- Current and prospective financing requirements (a potential related business risk might be, e.g., the loss of financing due to the company's inability to meet financing requirements.)

- Regulatory requirements (a potential related business risk might be, e.g., that there is increased legal exposure.)

  Note: Business risks could affect risks of material misstatement at the financial statement level, which would affect many accounts and disclosures in the financial statements. For example, a company's loss of financing or declining conditions affecting the company's industry could affect its ability to settle its obligations when due. This, in turn, could affect the risks of material misstatement related to, e.g., the classification of long-term liabilities or valuation of long-term assets, or it could result in substantial doubt about the company's ability to continue as a going concern. Other business risks could affect the risks of material misstatement for particular accounts, disclosures, or assertions. For example, an unsuccessful new product or service or failed business expansion might affect the risks of material misstatement related to the valuation of inventory and other related assets.

Company Performance Measures

16. The purpose of obtaining an understanding of the company's performance measures is to identify performance measures, whether external or internal, that affect the risks of material misstatement.

17. The following are examples of performance measures that might affect the risks of material misstatement:

- Measures that form the basis for contractual commitments or incentive compensation arrangements;

- Measures used by external parties, such as analysts and rating agencies, to review the company's performance; and

- Measures the company uses to monitor its operations that highlight unexpected results or trends that prompt management to investigate their cause and take corrective action, including correction of misstatements.

> Note: The first two examples represent performance measures that can affect the risks of material misstatement by creating incentives or pressures for management of the company to manipulate certain accounts or disclosures to achieve certain performance targets (or conceal a failure to achieve those targets). The third example represents performance measures that management might use to monitor risks affecting the financial statements.
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> Note: Smaller companies might have less formal processes to measure and review financial performance. In such cases, the auditor might identify relevant performance measures by considering the information that the company uses to manage the business.

Obtaining an Understanding of Internal Control Over Financial Reporting

18. The auditor should obtain a sufficient understanding of each component[8/] of internal control over financial reporting ("understanding of internal control") to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.

19. The nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company;[9/] the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting.

> Note: The auditor also might obtain an understanding of certain controls that are not part of internal control over financial reporting,

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[8/] Paragraphs 21-22 of this standard discuss components of internal control over financial reporting.

[9/] Paragraph 13 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, states, "The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its control objectives. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks."

e.g., controls over the completeness and accuracy of operating or other nonfinancial information used as audit evidence.[10/]

20. Obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.

Note: Procedures the auditor performs to obtain evidence about design effectiveness include inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs, as described in paragraphs 37-38, that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Note: Determining whether a control has been implemented means determining whether the control exists and whether the company is using it. The procedures to determine whether a control has been implemented may be performed in connection with the evaluation of its design. Procedures performed to determine whether a control has been implemented include inquiry of appropriate personnel, in combination with observation of the application of controls or inspection of documentation. Walkthroughs, as described in paragraphs 37-38, that include these procedures ordinarily are sufficient to determine whether a control has been implemented.

21. Internal control over financial reporting can be described as consisting of the following components:[11/]

- The control environment,
- The company's risk assessment process,
- Information and communication,
- Control activities, and
- Monitoring of controls.

[10/] Paragraph 10 of Auditing Standard No. 15.

[11/] Different internal control frameworks use different terms and approaches to describe the components of internal control over financial reporting.

22. Management might use an internal control framework with components that differ from the components identified in the preceding paragraph when establishing and maintaining the company's internal control over financial reporting. In evaluating the design of controls and determining whether they have been implemented in an audit of financial statements only, the auditor may use the framework used by management or another suitable, recognized framework.[12/] For integrated audits, Auditing Standard No. 5, states, "The auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting."[13/] If the auditor uses a suitable, recognized internal control framework with components that differ from those listed in the preceding paragraph, the auditor should adapt the requirements in paragraphs 23-36 of this standard to conform to the components in the framework used.

Control Environment

23. The auditor should obtain an understanding of the company's control environment, including the policies and actions of management, the board, and the audit committee concerning the company's control environment.

24. Obtaining an understanding of the control environment includes assessing:

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

  Note: In an audit of financial statements only, this assessment may be based on the evidence obtained in understanding the control environment, in accordance with paragraph 23, and the other relevant knowledge possessed by the auditor. In an integrated audit of financial statements and internal control over financial reporting, Auditing

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[12/] See Securities Exchange Act Release No. 34-47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

[13/] Paragraph 5 of Auditing Standard No. 5.

Standard No. 5[14/] describes the auditor's responsibility for evaluating the control environment.

25. If the auditor identifies a control deficiency[15/] in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor, as discussed in paragraphs 65-66 of this standard.

The Company's Risk Assessment Process

26. The auditor should obtain an understanding of management's process for:

a. Identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud ("fraud risks");

b. Assessing the likelihood and significance of misstatements resulting from those risks; and

c. Deciding about actions to address those risks.

27. Obtaining an understanding of the company's risk assessment process includes obtaining an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.

Information and Communication

28. *Information System Relevant to Financial Reporting.* The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including:

a. The classes of transactions in the company's operations that are significant to the financial statements;

b. The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported;

c. The related accounting records, supporting information, and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions;

14/ Paragraph 25 of Auditing Standard No. 5.

15/ Paragraph A3 of Auditing Standard No. 5.

d. How the information system captures events and conditions, other than transactions,[16] that are significant to the financial statements; and

e. The period-end financial reporting process.

> Note: Appendix B discusses additional considerations regarding manual and automated systems and controls.

29. The auditor also should obtain an understanding of how IT affects the company's flow of transactions. (See Appendix B.)

> Note: The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the approach used to identify significant accounts and disclosures and their relevant assertions and, when applicable, to select the controls to test, as well as to assess risk and allocate audit effort.

30. A company's business processes are the activities designed to:

a. Develop, purchase, produce, sell and distribute a company's products or services;

b. Record information, including accounting and financial reporting information; and

c. Ensure compliance with laws and regulations relevant to the financial statements.

31. Obtaining an understanding of the company's business processes assists the auditor in obtaining an understanding of how transactions are initiated, authorized, processed, and recorded.

32. A company's period-end financial reporting process, as referred to in paragraph 28.e., includes the following:

- Procedures used to enter transaction totals into the general ledger;

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[16] Examples of such events and conditions include depreciation and amortization and conditions affecting the recoverability of assets.

- Procedures related to the selection and application of accounting principles;[17/]
- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- Procedures used to record recurring and nonrecurring adjustments to the annual financial statements (and quarterly financial statements, if applicable); and
- Procedures for preparing annual financial statements and related disclosures (and quarterly financial statements, if applicable).

33. *Communication.* The auditor should obtain an understanding of how the company communicates financial reporting roles and responsibilities and significant matters relating to financial reporting to relevant company personnel and others, including:

- Communications between management, the audit committee, and the board of directors; and
- Communications to external parties, including regulatory authorities and shareholders.

Control Activities

34. The auditor should obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures, as described in paragraph 18 of this standard.[18/] As the auditor obtains an understanding of the other components of internal control over financial reporting, he or she is also likely to obtain knowledge about some control activities. The auditor should use his or her knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control over financial reporting in determining the extent to which it is necessary to devote additional attention to obtaining an understanding of control activities to assess the factors that affect the risks of material misstatement and to design further audit procedures.

> Note: A broader understanding of control activities is needed for relevant assertions for which the auditor plans to rely on controls. Also, in the audit of internal control over financial reporting, the

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[17/] Paragraphs 12-13 of this standard.

[18/] Also see paragraph B5 of Appendix B of this standard.

auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit.

Monitoring of Controls

35. The auditor should obtain an understanding of the major types of activities that the company uses to monitor the effectiveness of its internal control over financial reporting and how the company initiates corrective actions related to its controls.[19/]

36. An understanding of the company's monitoring activities includes understanding the source of the information used in the monitoring activities.

Performing Walkthroughs

37. As discussed in paragraph 20, the auditor may perform walkthroughs as part of obtaining an understanding of internal control over financial reporting. For example, the auditor may perform walkthroughs in connection with understanding the flow of transactions in the information system relevant to financial reporting, evaluating the design of controls relevant to the audit, and determining whether those controls have been implemented. In performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and IT that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

> Note: For integrated audits, Auditing Standard No. 5 establishes certain objectives that the auditor should achieve to further understand likely sources of potential misstatements and as part of selecting the controls to test. Auditing Standard No. 5 states that performing walkthroughs will frequently be the most effective way of achieving those objectives.[20/]

38. In performing a walkthrough, at the points at which important processing procedures occur, the auditor questions the company's personnel about their

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[19/] In some companies, internal auditors or others performing an equivalent function contribute to the monitoring of controls. AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* establishes requirements regarding the auditor's consideration and use of the work of the internal audit function.

[20/] See paragraphs 34-38 of Auditing Standard No. 5.

understanding of what is required by the company's prescribed procedures and controls. These probing questions, combined with the other walkthrough procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the auditor to gain an understanding of the different types of significant transactions handled by the process.

Relationship of Understanding of Internal Control to Tests of Controls

39. The objective of obtaining an understanding of internal control, as discussed in paragraph 18 of this standard, is different from testing controls for the purpose of assessing control risk[21/] or for the purpose of expressing an opinion on internal control over financial reporting in the audit of internal control over financial reporting.[22/] The auditor may obtain an understanding of internal control concurrently with performing tests of controls if he or she obtains sufficient appropriate evidence to achieve the objectives of both procedures. Also, the auditor should take into account the evidence obtained from understanding internal control when assessing control risk and, in the audit of internal control over financial reporting, forming an opinion about the effectiveness of internal control over financial reporting.

40. *Relationship of Understanding of Internal Control to Evaluating Entity-Level Controls in an Audit of Internal Control Over Financial Reporting.* Auditing Standard No. 5 states, "The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting."[23/] The procedures performed to obtain an understanding of certain components of internal control in accordance with this standard, e.g., the control environment, the company's risk assessment process, information and communication, and monitoring of controls, might provide evidence that is relevant to the auditor's evaluation of entity-level controls.[24/] The auditor should take into account the evidence obtained from

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[21/] Paragraphs 16-35 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

[22/] Paragraph B1 of Auditing Standard No. 5.

[23/] Paragraph 22 of Auditing Standard No. 5.

[24/] The entity-level controls included in paragraph 24 of Auditing Standard No. 5 include controls related to the control environment; the understanding internal control when determining the nature, timing, and extent of procedures necessary to support the auditor's conclusions about the effectiveness of entity-level controls in the audit of internal control over financial reporting.

Considering Information from the Client Acceptance and Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements

41. *Client Acceptance and Retention and Audit Planning Activities.* The auditor should evaluate whether information obtained from the client acceptance and retention evaluation process or audit planning activities is relevant to identifying risks of material misstatement. Risks of material misstatement identified during those activities should be assessed as discussed beginning in paragraph 59 of this standard.

42. *Past Audits.* In subsequent years, the auditor should incorporate knowledge obtained during past audits into the auditor's process for identifying risks of material misstatement, including when identifying significant ongoing matters that affect the risks of material misstatement or determining how changes in the company or its environment affect the risks of material misstatement, as discussed in paragraph 8 of this standard.

43. If the auditor plans to limit the nature, timing, or extent of his or her risk assessment procedures by relying on information from past audits, the auditor should evaluate whether the prior years' information remains relevant and reliable.

44. *Other Engagements.* When the auditor has performed a review of interim financial information in accordance with AU sec. 722, *Interim Financial Information,* the auditor should evaluate whether information obtained during the review is relevant to identifying risks of material misstatement in the year-end audit.

45. The auditor should obtain an understanding of the nature of the services that have been performed for the company by the auditor or affiliates of the

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company's risk assessment process; centralized processing and controls; controls over the period-end financial reporting process; and controls to monitor other controls.

firm[25] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement.[26]

Performing Analytical Procedures

46. The auditor should perform analytical procedures that are designed to:

   a. Enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior year end; and

   b. Identify areas that might represent specific risks relevant to the audit, including the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.

47. In applying analytical procedures as risk assessment procedures, the auditor should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud. Also, when the auditor has performed a review of interim financial information in accordance with AU sec. 722, he or she should take into account the analytical procedures applied in that review when designing and applying analytical procedures as risk assessment procedures.

48. When performing an analytical procedure, the auditor should use his or her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure.[27] When comparison of those expectations with relationships derived from recorded amounts yields unusual or unexpected results, the auditor should take into account those results in identifying the risks of material misstatement.

> Note: Analytical procedures performed as risk assessment procedures often use data that is preliminary or data that is aggregated at a high level, and, in those instances, such analytical procedures are not designed with the level of precision necessary for substantive analytical procedures.

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[25] See PCAOB Rule 3501(a)(i), which defines "affiliate of the accounting firm."

[26] Paragraph 7 of Auditing Standard No. 9, *Audit Planning.*

[27] Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

Conducting a Discussion among Engagement Team Members Regarding Risks of Material Misstatement

49. The key engagement team members should discuss (1) the company's selection and application of accounting principles, including related disclosure requirements, and (2) the susceptibility of the company's financial statements to material misstatement due to error or fraud.

> Note: The key engagement team members should discuss the potential for material misstatement due to fraud either as part of the discussion regarding risks of material misstatement or in a separate discussion.[28/]

> Note: As discussed in paragraph 67, the financial statements might be susceptible to misstatement through omission of required disclosures or presentation of inaccurate or incomplete disclosures.

50. Key engagement team members include all engagement team members who have significant engagement responsibilities, including the engagement partner. The manner in which the discussion is conducted depends on the individuals involved and the circumstances of the engagement. For example, if the audit involves more than one location, there could be multiple discussions with team members in differing locations. The engagement partner or other key engagement team members should communicate the important matters from the discussion to engagement team members who are not involved in the discussion.

> Note: If the audit is performed entirely by the engagement partner, that engagement partner, having personally conducted the planning of the audit, is responsible for evaluating the susceptibility of the company's financial statements to material misstatement.

51. Communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change.[29/]

Discussion of the Potential for Material Misstatement Due to Fraud

52. The discussion among the key engagement team members about the potential for material misstatement due to fraud should occur with an attitude that includes a questioning mind, and the key engagement team members should set

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[28/] Paragraphs 52-53 of this standard.

[29/] See also paragraph 29 of Auditing Standard No. 14, *Evaluating Audit Results*.

aside any prior beliefs they might have that management is honest and has integrity. The discussion among the key engagement team members should include:

- An exchange of ideas, or "brainstorming," among the key engagement team members, including the engagement partner, about how and where they believe the company's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the company could be misappropriated, including (a) the susceptibility of the financial statements to material misstatement through related party transactions and (b) how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures;

- A consideration of the known external and internal factors affecting the company that might (a) create incentives or pressures for management and others to commit fraud, (b) provide the opportunity for fraud to be perpetrated, and (c) indicate a culture or environment that enables management to rationalize committing fraud;

- A consideration of the risk of management override; and

- A consideration of the potential audit responses to the susceptibility of the company's financial statements to material misstatement due to fraud.

53. The auditor should emphasize the following matters to all engagement team members:

- The need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, as described in AU sec. 316;[30/]

- The need to be alert for information or other conditions (such as those matters presented in Appendix C of Auditing Standard No. 14) that might affect the assessment of fraud risks; and

- If information or other conditions indicate that a material misstatement due to fraud might have occurred, the need to probe the issues, acquire additional evidence as necessary, and consult

[30/] AU sec. 316.13.

with other team members and, if appropriate, others in the firm including specialists.[31/]

Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

54. The auditor should inquire of the audit committee, or equivalent (or its chair), management, the internal audit function, and others within the company who might reasonably be expected to have information that is important to the identification and assessment of risks of material misstatement.

Note: The auditor's inquiries about risks of material misstatement should include inquiries regarding fraud risks.

55. The auditor should use his or her knowledge of the company and its environment, as well as information from other risk assessment procedures, to determine the nature of the inquiries about risks of material misstatement.

Inquiries Regarding Fraud Risks

56. The auditor's inquiries regarding fraud risks should include the following:

a. Inquiries of management regarding:

(1) Whether management has knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

(2) Management's process for identifying and responding to fraud risks in the company, including any specific fraud risks the company has identified or account balances or disclosures for which a fraud risk is likely to exist, and the nature, extent, and frequency of management's fraud risk assessment process;

(3) Controls that the company has established to address fraud risks the company has identified, or that otherwise help to prevent and detect fraud, including how management monitors those controls;

(4) For a company with multiple locations (a) the nature and extent of monitoring of operating locations or business

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[31/] Paragraphs 20-23 of Auditing Standard No. 14 establish further requirements for evaluating whether misstatements might be indicative of fraud and determining the necessary procedures to be performed in those situations.

segments and (b) whether there are particular operating locations or business segments for which a fraud risk might be more likely to exist;

(5) Whether and how management communicates to employees its views on business practices and ethical behavior;

(6) Whether management has received tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, management's responses to such tips and complaints; and

(7) Whether management has reported to the audit committee on how the company's internal control serves to prevent and detect material misstatements due to fraud.

b. Inquiries of the audit committee, or equivalent, or its chair regarding:

(1) The audit committee's views about fraud risks in the company;

(2) Whether the audit committee has knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

(3) Whether the audit committee is aware of tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, the audit committee's responses to such tips and complaints; and

(4) How the audit committee exercises oversight of the company's assessment of fraud risks and the establishment of controls to address fraud risks.

c. If the company has an internal audit function, inquiries of appropriate internal audit personnel regarding:

(1) The internal auditors' views about fraud risks in the company;

(2) Whether the internal auditors have knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

(3) Whether internal auditors have performed procedures to identify or detect fraud during the year, and whether management has satisfactorily responded to the findings resulting from those procedures; and

(4) Whether internal auditors are aware of instances of management override of controls and the nature and circumstances of such overrides.

57. In addition to the inquiries outlined in the preceding paragraph, the auditor should inquire of others within the company about their views regarding fraud risks, including, in particular, whether they have knowledge of fraud, alleged fraud, or suspected fraud. The auditor should identify other individuals within the company to whom inquiries should be directed and determine the extent of such inquiries by considering whether others in the company might have additional knowledge about fraud, alleged fraud, or suspected fraud or might be able to corroborate fraud risks identified in discussions with management or the audit committee. Examples of other individuals within the company to whom inquiries might be directed include:

- Employees with varying levels of authority within the company, including, e.g., company personnel with whom the auditor comes into contact during the course of the audit (a) in obtaining an understanding of internal control, (b) in observing inventory or performing cutoff procedures, or (c) in obtaining explanations for significant differences identified when performing analytical procedures;
- Operating personnel not directly involved in the financial reporting process;
- Employees involved in initiating, recording, or processing complex or unusual transactions, e.g., a sales transaction with multiple elements or a significant related party transaction; and
- In-house legal counsel.

58. When evaluating management's responses to inquiries about fraud risks and determining when it is necessary to corroborate management's responses, the auditor should take into account the fact that management is often in the best position to commit fraud. Also, the auditor should obtain evidence to address inconsistencies in responses to the inquiries.

Identifying and Assessing the Risks of Material Misstatement

59. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. In identifying and assessing risks of material misstatement, the auditor should:

a. Identify risks of misstatement using information obtained from performing risk assessment procedures (as discussed in paragraphs 4-58) and considering the characteristics of the accounts and disclosures in the financial statements.

   Note: Factors relevant to identifying fraud risks are discussed in paragraphs 65-69 of this standard.

b. Evaluate whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions.

c. Evaluate the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected.

   Note: In identifying and assessing risks at the assertion level, the auditor should evaluate how risks at the financial statement level could affect risks of misstatement at the assertion level.

d. Assess the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements.

   Note: In assessing the likelihood and magnitude of potential misstatement, the auditor may take into account the planned degree of reliance on controls selected to test.[32/]

[32/] Paragraphs 16-35 of Auditing Standard No. 13.

e. Identify significant accounts and disclosures[33/] and their relevant assertions[34/] (paragraphs 60-64 of this standard).

> Note: The determination of whether an account or disclosure is significant or whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

f. Determine whether any of the identified and assessed risks of material misstatement are **significant risks** (paragraphs 70-71 of this standard).

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

60. To identify significant accounts and disclosures and their relevant assertions in accordance with paragraph 59.e., the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include:

- Size and composition of the account;
- Susceptibility to misstatement due to error or fraud;

33/ Paragraph A10 of Auditing Standard No. 5 states:

> An account or disclosure is a significant account or disclosure if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.

34/ Paragraph A9 of Auditing Standard No. 5 states:

> A relevant assertion is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;
- Exposure to losses in the account;
- Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- Existence of related party transactions in the account; and
- Changes from the prior period in account and disclosure characteristics.

61. As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.

62. The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the audit of internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits.

> Note: In the financial statement audit, the auditor might perform substantive auditing procedures on financial statement accounts, disclosures, and assertions that are not determined to be significant accounts and disclosures and relevant assertions.[35/]

[35/] The auditor might perform substantive auditing procedures because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high or as a means of introducing unpredictability in the procedures performed. See paragraphs 11, 14, and 25 of Auditing Standard No. 14, for further discussion about undetected misstatement. See paragraph 61 of Auditing Standard No. 5

63. The components of a potential significant account or disclosure might be subject to significantly differing risks.

64. When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements.

Factors Relevant to Identifying Fraud Risks

65. The auditor should evaluate whether the information gathered from the risk assessment procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks. Fraud risk factors are events or conditions that indicate (1) an incentive or pressure to perpetrate fraud, (2) an opportunity to carry out the fraud, or (3) an attitude or rationalization that justifies the fraudulent action. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances in which fraud exists. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are listed in AU sec. 316.85*.* These illustrative risk factors are classified based on the three conditions discussed in this paragraph, which generally are present when fraud exists.

> Note: The factors listed in AU sec. 316.85 cover a broad range of situations and are only examples. Accordingly, the auditor might identify additional or different fraud risk factors.

66. All three conditions discussed in the preceding paragraph are not required to be observed or evident to conclude that a fraud risk exists. The auditor might conclude that a fraud risk exists even when only one of these three conditions is present.

67. *Consideration of the Risk of Omitted, Incomplete, or Inaccurate Disclosures.* The auditor's evaluation of fraud risk factors in accordance with paragraph 65 should include evaluation of how fraud could be perpetrated or concealed by presenting incomplete or inaccurate disclosures or by omitting disclosures that are necessary for the financial statements to be presented fairly in conformity with the applicable financial reporting framework.

68. *Presumption of Fraud Risk Involving Improper Revenue Recognition.* The auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.

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and paragraph 5.c. of Auditing Standard No. 13, for further discussion about the unpredictability of auditing procedures.

69. *Consideration of the Risk of Management Override of Controls.* The auditor's identification of fraud risks should include the risk of management override of controls.

> Note: Controls over management override are important to effective internal control over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override.

Factors Relevant to Identifying Significant Risks

70. To determine whether an identified and assessed risk is a significant risk, the auditor should evaluate whether the risk requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk.

> Note: The determination of whether a risk of material misstatement is a significant risk is based on inherent risk, without regard to the effect of controls.

71. Factors that should be evaluated in determining which risks are significant risks include:

a. The effect of the quantitative and qualitative risk factors discussed in paragraph 60 on the likelihood and potential magnitude of misstatements;

b. Whether the risk is a fraud risk;

> Note: A fraud risk is a significant risk.

c. Whether the risk is related to recent significant economic, accounting, or other developments;

d. The complexity of transactions;

e. Whether the risk involves significant transactions with related parties;

f. The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

g. Whether the risk involves significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature.

Further Consideration of Controls

72. When the auditor has determined that a significant risk, including a fraud risk, exists, the auditor should evaluate the design of the company's controls that are intended to address fraud risks and other significant risks and determine whether those controls have been implemented, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18-40 of this standard.[36/]

73. Controls that address fraud risks include (a) specific controls designed to mitigate specific risks of fraud, e.g., controls to address risks of intentional misstatement of specific accounts and (b) controls designed to prevent, deter, and detect fraud, e.g., controls to promote a culture of honesty and ethical behavior.[37/] Such controls also include those that address the risk of management override of other controls.

Revision of Risk Assessment

74. The auditor's assessment of the risks of material misstatement, including fraud risks, should continue throughout the audit. When the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.[38/]

[36/] Auditing Standard No. 13 discusses the auditor's response to fraud risks and other significant risks.

[37/] AU sec. 316.88 and paragraph 14 of Auditing Standard No. 5 present examples of controls that address fraud risks.

[38/] See also paragraph 46 of Auditing Standard No. 13.

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Business risks – Risks that result from significant conditions, events, circumstances, actions, or inactions that could adversely affect a company's ability to achieve its objectives and execute its strategies. Business risks also might result from setting inappropriate objectives and strategies or from changes or complexity in the company's operations or management.

A3. Company's objectives and strategies – The overall plans for the company as established by management or the board of directors. Strategies are the approaches by which management intends to achieve its objectives.

A4. Risk assessment procedures – The procedures performed by the auditor to obtain information for identifying and assessing the risks of material misstatement in the financial statements whether due to error or fraud.

> Note: Risk assessment procedures by themselves do not provide sufficient appropriate evidence on which to base an audit opinion.

A5. Significant risk – A risk of material misstatement that requires special audit consideration.

APPENDIX B – Consideration of Manual and Automated Systems and Controls

B1. While obtaining an understanding of the company's information system related to financial reporting, the auditor should obtain an understanding of how the company uses information technology ("IT") and how IT affects the financial statements.[1/] The auditor also should obtain an understanding of the extent of manual controls and automated controls used by the company, including the IT general controls that are important to the effective operation of the automated controls. That information should be taken into account in assessing the risks of material misstatement.[2/]

B2. Controls in a manual system might include procedures such as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items.

B3. Alternatively, a company might use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format would replace paper documents. When IT is used to initiate, record, process, and report transactions, the IT systems and programs may include controls related to the relevant assertions of significant accounts and disclosures or may be critical to the effective functioning of manual controls that depend on IT.

B4. The auditor should obtain an understanding of specific risks to a company's internal control over financial reporting resulting from IT. Examples of such risks include:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both;

- Unauthorized access to data that might result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions or inaccurate recording of transactions (particular risks might arise when multiple users access a common database);

[1/] See also AU sec. 324, *Service Organizations,* if the company uses a service organization for services that are part of the company's internal control over financial reporting.

[2/] See also paragraphs 16-17 of Auditing Standard No. 9, *Audit Planning*.

- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down segregation of duties;
- Unauthorized changes to data in master files;
- Unauthorized changes to systems or programs;
- Failure to make necessary changes to systems or programs;
- Inappropriate manual intervention; and
- Potential loss of data or inability to access data as required.

B5. In obtaining an understanding of the company's control activities, the auditor should obtain an understanding of how the company has responded to risks arising from IT.

B6. When a company uses manual elements in internal control systems and the auditor plans to rely on, and therefore test, those manual controls, the auditor should design procedures to test the consistency in the application of those manual controls.

Auditing Standard No. 13

The Auditor's Responses to the Risks of Material Misstatement

Introduction

1. This standard establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement.

Objective

2. The objective of the auditor is to address the risks of material misstatement through appropriate overall audit responses and audit procedures.

Responding to the Risks of Material Misstatement

3. To meet the objective in the preceding paragraph, the auditor must design and implement audit responses that address the risks of material misstatement that are identified and assessed in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

4. This standard discusses the following types of audit responses:

   a. Responses that have an overall effect on how the audit is conducted ("overall responses"), as described in paragraphs 5-7; and

   b. Responses involving the nature, timing, and extent of the audit procedures to be performed, as described in paragraphs 8-46.

Overall Responses

5. The auditor should design and implement overall responses to address the assessed risks of material misstatement as follows:

   a. *Making appropriate assignments of significant engagement responsibilities.* The knowledge, skill, and ability of engagement team members with significant engagement responsibilities should be commensurate with the assessed risks of material misstatement.[1/]

[1/] See also paragraph .06 of AU sec. 230, *Due Professional Care in the Performance of Work.*

b. *Providing the extent of supervision that is appropriate for the circumstances, including, in particular, the assessed risks of material misstatement.* (See paragraphs 5–6 of Auditing Standard No. 10, *Supervision of the Audit Engagement*.)

c. *Incorporating elements of unpredictability in the selection of audit procedures to be performed.* As part of the auditor's response to the assessed risks of material misstatement, including the assessed risks of material misstatement due to fraud ("fraud risks"), the auditor should incorporate an element of unpredictability in the selection of auditing procedures to be performed from year to year. Examples of ways to incorporate an element of unpredictability include:

(1) Performing audit procedures related to accounts, disclosures, and assertions that would not otherwise be tested based on their amount or the auditor's assessment of risk;

(2) Varying the timing of the audit procedures;

(3) Selecting items for testing that have lower amounts or are otherwise outside customary selection parameters;

(4) Performing audit procedures on an unannounced basis; and

(5) In multi-location audits, varying the location or the nature, timing, and extent of audit procedures at related locations or business units from year to year.[2/]

d. *Evaluating the company's selection and application of significant accounting principles.* The auditor should evaluate whether the company's selection and application of significant accounting principles, particularly those related to subjective measurements

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[2/] For integrated audits, paragraphs 61 and B13 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, establish requirements for introducing unpredictability in testing of controls from year to year and in multi-location audits.

and complex transactions,[3] are indicative of bias that could lead to material misstatement of the financial statements.

> Note: Paragraph .11 of AU sec. 380, *Communication With Audit Committees,* discusses the auditor's judgments about the quality of a company's accounting principles.

6. The auditor also should determine whether it is necessary to make pervasive changes to the nature, timing, or extent of audit procedures to adequately address the assessed risks of material misstatement. Examples of such pervasive changes include modifying the audit strategy to:

a. Increase the substantive testing of the valuation of numerous significant accounts at year end because of significantly deteriorating market conditions, and

b. Obtain more persuasive audit evidence from substantive procedures due to the identification of pervasive weaknesses in the company's control environment.

7. Due professional care requires the auditor to exercise professional skepticism.[4] Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence. The auditor's responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence.[5] Examples of the application of professional skepticism in response to the assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or

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[3] Paragraphs 12-13 of Auditing Standard No. 12 discuss the auditor's responsibilities regarding obtaining an understanding of the company's selection and application of accounting principles. See also paragraphs .66-.67 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* and paragraphs .04 and .06 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.*

[4] AU secs. 230.07-.09.

[5] AU sec. 316.13.

employed by the auditor, or examination of documentation from independent sources.

Responses Involving the Nature, Timing, and Extent of Audit Procedures

8. The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.

9. In designing the audit procedures to be performed, the auditor should:

   a. Obtain more persuasive audit evidence the higher the auditor's assessment of risk;

   b. Take into account the types of potential misstatements that could result from the identified risks and the likelihood and magnitude of potential misstatement;[6/]

   c. In an integrated audit, design the testing of controls to accomplish the objectives of both audits simultaneously:

      (1) To obtain sufficient evidence to support the auditor's control risk[7/] assessments for purposes of the audit of financial statements;[8/] and

      (2) To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end.

         Note: Auditing Standard No. 5 establishes requirements for tests of controls in the audit of internal control over financial reporting.

6/ For example, potential misstatements regarding disclosures include omission of required disclosures or presentation of inaccurate or incomplete disclosures.

7/ See paragraph 7.b. of Auditing Standard No. 8, *Audit Risk,* for a definition of control risk.

8/ For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

10. The audit procedures performed in response to the assessed risks of material misstatement can be classified into two categories: (1) tests of controls and (2) substantive procedures.[9/] Paragraphs 16-35 of this standard discuss tests of controls, and paragraphs 36-46 discuss substantive procedures.

> Note: Paragraphs 16-17 of this standard discuss when tests of controls are necessary in a financial statement audit. Ordinarily, tests of controls are performed for relevant assertions for which the auditor chooses to rely on controls to modify his or her substantive procedures.

Responses to Significant Risks

11. For significant risks, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed risks.

> Note: Auditing Standard No. 12 discusses identification of significant risks[10/] and states that fraud risks are significant risks.

Responses to Fraud Risks

12. The audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected.

> Note: If the auditor identifies deficiencies in controls that are intended to address assessed fraud risks, the auditor should take into account those deficiencies when designing his or her response to those fraud risks.

> Note: Auditing Standard No. 5 establishes requirements for addressing assessed fraud risks in the audit of internal control over financial reporting.[11/]

[9/] Substantive procedures consist of (a) tests of details of accounts and disclosures and (b) substantive analytical procedures.

[10/] See paragraph 71 of Auditing Standard No. 12 for factors that the auditor should evaluate in determining which risks are significant risks.

[11/] Paragraphs 14-15 of Auditing Standard No. 5.

13. *Addressing Fraud Risks in the Audit of Financial Statements.* In the audit of financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks. If the auditor selects certain controls intended to address the assessed fraud risks for testing in accordance with paragraphs 16-17 of this standard, the auditor should perform tests of those controls.

14. The following are examples of ways in which planned audit procedures may be modified to address assessed fraud risks:

a. Changing the *nature* of audit procedures to obtain evidence that is more reliable or to obtain additional corroborative information;

b. Changing the *timing* of audit procedures to be closer to the end of the period or to the points during the period in which fraudulent transactions are more likely to occur; and

c. Changing the *extent* of the procedures applied to obtain more evidence, e.g., by increasing sample sizes or applying computer-assisted audit techniques to all of the items in an account.

> Note: AU secs. 316.54-.67 provide additional examples of responses to assessed fraud risks relating to fraudulent financial reporting (e.g., revenue recognition, inventory quantities, and management estimates) and misappropriation of assets in the audit of financial statements.

15. Also, AU sec. 316 indicates that the auditor should perform audit procedures to specifically address the risk of management override of controls including:

a. Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud (AU secs. 316.58-.62);

b. Reviewing accounting estimates for biases that could result in material misstatement due to fraud (AU secs. 316.63-.65); and

c. Evaluating the business rationale for significant unusual transactions (AU secs. 316.66-.67).

Testing Controls

Testing Controls in an Audit of Financial Statements

16. *Controls to be Tested.* If the auditor plans to assess control risk at less than the maximum by relying on controls,[12/] and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire **period of reliance**.[13/] However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

17. Also, tests of controls must be performed in the audit of financial statements for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence and when necessary to support the auditor's reliance on the accuracy and completeness of financial information used in performing other audit procedures.[14/]

> Note*:* When a significant amount of information supporting one or more relevant assertions is electronically initiated, recorded, processed, or reported, it might be impossible to design effective substantive tests that, by themselves, would provide sufficient appropriate evidence regarding the assertions. For such assertions, significant audit evidence may be available only in electronic form. In such cases, the sufficiency and appropriateness of the audit evidence usually depend on the effectiveness of controls over their accuracy and completeness. Furthermore, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded,

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[12/] Reliance on controls that is supported by sufficient and appropriate audit evidence allows the auditor to assess control risk at less than the maximum, which results in a lower assessed risk of material misstatement. In turn, this allows the auditor to modify the nature, timing, and extent of planned substantive procedures.

[13/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

[14/] Paragraph 10 of Auditing Standard No. 15, *Audit Evidence,* and paragraph .16 of AU sec. 329, *Substantive Analytical Procedures.*

processed, or reported only in electronic form and appropriate controls are not operating effectively.

18. *Evidence about the Effectiveness of Controls in the Audit of Financial Statements.* In designing and performing tests of controls for the audit of financial statements, the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The auditor should obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. The auditor also should obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.

Testing Design Effectiveness

19. The auditor should test the design effectiveness of the controls selected for testing by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect error or fraud that could result in material misstatements in the financial statements.

> Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.

20. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.[15/]

[15/] Paragraphs 37-38 of Auditing Standard No. 12 discuss performing a walkthrough.

Testing Operating Effectiveness

21. The auditor should test the operating effectiveness of a control selected for testing by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

22. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Obtaining Evidence from Tests of Controls

23. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing might provide sufficient evidence in relation to the degree of reliance in an audit of financial statements.

> Note: To obtain evidence about whether a control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures.

Nature of Tests of Controls

24. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in the order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control.

> Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.

25. The nature of the tests of controls that will provide appropriate evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

> Note: A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with

other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain controls, might provide sufficient evidence about whether the control is effective.

Extent of Tests of Controls

26. The more extensively a control is tested, the greater the evidence obtained from that test.

27. Matters that could affect the necessary extent of testing of a control in relation to the degree of reliance on a control include the following:

- The frequency of the performance of the control by the company during the audit period;
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control;
- The expected rate of deviation from a control;
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control;
- The extent to which audit evidence is obtained from tests of other controls related to the assertion;
- The nature of the control, including, in particular, whether it is a manual control or an automated control; and
- For an automated control, the effectiveness of relevant information technology general controls.

Note: AU sec. 350, *Audit Sampling,* establishes requirements regarding the use of sampling in tests of controls.

Timing of Tests of Controls

28. The timing of tests of controls relates to when the evidence about the operating effectiveness of the controls is obtained and the period of time to which it applies. Paragraph 16 of this standard indicates that the auditor must obtain

evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance.

29. *Using Audit Evidence Obtained during an Interim Period.* When the auditor obtains evidence about the operating effectiveness of controls as of or through an interim date, he or she should determine what additional evidence is necessary concerning the operation of the controls for the remaining period of reliance.

30. The additional evidence that is necessary to update the results of testing from an interim date through the remaining period of reliance depends on the following factors:

- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date;

  > Note: If there have been significant changes to the control since the interim date, the auditor should obtain evidence about the effectiveness of the new or modified control;

- The inherent risk associated with the related account(s) or assertion(s);
- The specific control tested prior to year end, including the nature of the control and the risk that the control is no longer effective during the remaining period, and the results of the tests of the control;
- The planned degree of reliance on the control;
- The sufficiency of the evidence of effectiveness obtained at an interim date; and
- The length of the remaining period.

31. *Using Audit Evidence Obtained in Past Audits.* For audits of financial statements, the auditor should obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies. When controls on which the auditor plans to rely have been tested in past audits and the auditor plans to use evidence about the effectiveness of those controls that was obtained in prior years, the auditor should take into account the

following factors to determine the evidence needed during the current year audit to support the auditor's control risk assessments:

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) or assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls that the auditor has tested, especially controls that monitor other controls;
- The nature of the controls and the frequency with which they operate;
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective);[16/]
- The complexity of the control and the significance of the judgments that must be made in connection with its operation;

[16/] The auditor also may use a benchmarking strategy, when appropriate, for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B28 of Auditing Standard No. 5.

- The planned degree of reliance on the control;
- The nature, timing, and extent of procedures performed in past audits;
- The results of the previous years' testing of the control;
- Whether there have been changes in the control or the process in which it operates since the previous audit; and
- For integrated audits, the evidence regarding the effectiveness of the controls obtained during the audit of internal control.

Assessing Control Risk

32. The auditor should assess control risk for relevant assertions by evaluating the evidence obtained from all sources, including the auditor's testing of controls for the audit of internal control and the audit of financial statements, misstatements detected during the financial statement audit, and any identified control deficiencies.

33. Control risk should be assessed at the maximum level for relevant assertions (1) for which controls necessary to sufficiently address the assessed risk of material misstatement in those assertions are missing or ineffective or (2) when the auditor has not obtained sufficient appropriate evidence to support a control risk assessment below the maximum level.

34. When deficiencies affecting the controls on which the auditor intends to rely are detected, the auditor should evaluate the severity of the deficiencies and the effect on the auditor's control risk assessments. If the auditor plans to rely on controls relating to an assertion but the controls that the auditor tests are ineffective because of control deficiencies, the auditor should:

a. Perform tests of other controls related to the same assertion as the ineffective controls, or

b. Revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased assessment of risk.

> Note: Auditing Standard No. 5 establishes requirements for evaluating the severity of a control deficiency and communicating identified control

deficiencies to management and the audit committee in an integrated audit. AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements,* establishes requirements for communicating significant deficiencies and material weaknesses in an audit of financial statements only.

Testing Controls in an Audit of Internal Control

35. Auditing Standard No. 5 states that the objective of the tests of controls in an audit of internal control is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a point in time and taken as a whole.[17/] Auditing Standard No. 5 establishes requirements regarding the selection of controls to be tested and the necessary nature, timing, and extent of tests of controls in an audit of internal control over financial reporting.

Substantive Procedures

36. The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.

37. As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures. Further, for an individual assertion, different combinations of the nature, timing, and extent of testing might provide sufficient appropriate evidence to respond to the assessed risk of material misstatement.

38. Internal control over financial reporting has inherent limitations,[18/] which, in turn, can affect the evidence that is needed from substantive procedures. For example, more evidence from substantive procedures ordinarily is needed for

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[17/] Paragraph B1 of Auditing Standard No. 5.

[18/] Paragraph A5 of Auditing Standard No. 5.

relevant assertions that have a higher susceptibility to management override or to lapses in judgment or breakdowns resulting from human failures.[19/]

Nature of Substantive Procedures

39. Substantive procedures generally provide persuasive evidence when they are designed and performed to obtain evidence that is relevant and reliable. Also, some types of substantive procedures, by their nature, produce more persuasive evidence than others. Inquiry alone does not provide sufficient appropriate evidence to support a conclusion about a relevant assertion.

> Note: Auditing Standard No. 15 discusses certain types of substantive procedures and the relevance and reliability of audit evidence.

40. Taking into account the types of potential misstatements in the relevant assertions that could result from identified risks, as required by paragraph 9.b., can help the auditor determine the types and combination of substantive audit procedures that are necessary to detect material misstatements in the respective assertions.

41. *Substantive Procedures Related to the Period-end Financial Reporting Process.* The auditor's substantive procedures must include the following audit procedures related to the period-end financial reporting process:

a. Reconciling the financial statements with the underlying accounting records; and

b. Examining material adjustments made during the course of preparing the financial statements.

> Note: AU secs. 316.58-.62 establish requirements for examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.

[19/] See, e.g., paragraph .14 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures.*

Extent of Substantive Procedures

42. The more extensively a substantive procedure is performed, the greater the evidence obtained from the procedure. The necessary extent of a substantive audit procedure depends on the materiality of the account or disclosure, the assessed risk of material misstatement, and the necessary degree of assurance from the procedure. However, increasing the extent of an audit procedure cannot adequately address an assessed risk of material misstatement unless the evidence to be obtained from the procedure is reliable and relevant.

Timing of Substantive Procedures

43. Performing certain substantive procedures at interim dates may permit early consideration of matters affecting the year-end financial statements, e.g., testing material transactions involving higher risks of misstatement. However, performing substantive procedures at an interim date without performing procedures at a later date increases the risk that a material misstatement could exist in the year-end financial statements that would not be detected by the auditor. This risk increases as the period between the interim date and year end increases.

44. In determining whether it is appropriate to perform substantive procedures at an interim date, the auditor should take into account the following:

a. The assessed risk of material misstatement, including:

   (1) The auditor's assessment of control risk, as discussed in paragraphs 32-34;

   (2) The existence of conditions or circumstances, if any, that create incentives or pressures on management to misstate the financial statements between the interim test date and the end of the period covered by the financial statements;

   (3) The effects of known or expected changes in the company, its environment, or its internal control over financial reporting during the remaining period;

b. The nature of the substantive procedures;

c. The nature of the account or disclosure and relevant assertion; and

d. The ability of the auditor to perform the necessary audit procedures to cover the remaining period.

45. When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. Such procedures should include (a) comparing relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual and investigating such amounts and (b) performing audit procedures to test the remaining period.

46. If the auditor obtains evidence that contradicts the evidence on which the original risk assessments were based, including evidence of misstatements that he or she did not expect, the auditor should revise the related risk assessments and modify the planned nature, timing, or extent of substantive procedures covering the remaining period as necessary. Examples of such modifications include extending or repeating at the period end the procedures performed at the interim date.

Dual-purpose Tests

47. In some situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction (a "**dual-purpose test**"). In those situations, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested.[20/]

[20/] Paragraph .44 of AU sec. 350 discusses applying audit sampling in dual-purpose tests.

<u>APPENDIX A</u> – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Dual-purpose test – Substantive test of a transaction and a test of a control relevant to that transaction that are performed concurrently, e.g., a substantive test of sales transactions performed concurrently with a test of controls over those transactions.

A3. Period of reliance – The period being covered by the company's financial statements, or the portion of that period, for which the auditor plans to rely on controls in order to modify the nature, timing, and extent of planned substantive procedures.

Auditing Standard No. 14

Evaluating Audit Results

Introduction

1. This standard establishes requirements regarding the auditor's evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.

Objective

2. The objective of the auditor is to evaluate the results of the audit to determine whether the audit evidence obtained is sufficient and appropriate to support the opinion to be expressed in the auditor's report.

Evaluating the Results of the Audit of Financial Statements

3. In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, the auditor should take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.

4. In the audit of financial statements,[1/] the auditor's evaluation of audit results should include evaluation of the following:

   a. The results of analytical procedures performed in the overall review of the financial statements ("overall review");

[1/] For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

b. **Misstatements** accumulated during the audit, including, in particular, **uncorrected misstatements**;[2/]

c. The qualitative aspects of the company's accounting practices;

d. Conditions identified during the audit that relate to the assessment of the risk of material misstatement due to fraud ("fraud risk");

e. The presentation of the financial statements, including the disclosures; and

f. The sufficiency and appropriateness of the audit evidence obtained.

Performing Analytical Procedures in the Overall Review

5. In the overall review, the auditor should read the financial statements and disclosures and perform analytical procedures to (a) evaluate the auditor's conclusions formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement.

6. As part of the overall review, the auditor should evaluate whether:

a. The evidence gathered in response to unusual or unexpected transactions, events, amounts, or relationships previously identified during the audit is sufficient; and

b. Unusual or unexpected transactions, events, amounts, or relationships[3/] indicate risks of material misstatement that were not identified previously, including, in particular, fraud risks.

> Note: If the auditor discovers a previously unidentified risk of material misstatement or concludes that the evidence gathered is not adequate, he or she should modify his or her audit

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[2/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

[3/] Paragraphs 46-48 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* and paragraph .03 of AU sec. 329, *Substantive Analytical Procedures.*

procedures or perform additional procedures as necessary in accordance with paragraph 36 of this standard.

7. The nature and extent of the analytical procedures performed during the overall review may be similar to the analytical procedures performed as risk assessment procedures. The auditor should perform analytical procedures relating to revenue through the end of the reporting period.[4/]

8. The auditor should obtain corroboration for management's explanations regarding significant unusual or unexpected transactions, events, amounts, or relationships. If management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures to address the matter.

9. *Evaluating Whether Analytical Procedures Indicate a Previously Unrecognized Fraud Risk.* Whether an unusual or unexpected transaction, event, amount, or relationship indicates a fraud risk, as discussed in paragraph 6.b., depends on the relevant facts and circumstances, including the nature of the account or relationship among the data used in the analytical procedures. For example, certain unusual or unexpected transactions, events, amounts, or relationships could indicate a fraud risk if a component of the relationship involves accounts and disclosures that management has incentives or pressures to manipulate, e.g., significant unusual or unexpected relationships involving revenue and income.

Accumulating and Evaluating Identified Misstatements

10. *Accumulating Identified Misstatements.* The auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial.

> Note: "Clearly trivial" is not another expression for "not material." Matters that are clearly trivial will be of a smaller order of magnitude than the materiality level established in accordance with Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit,* and will be inconsequential, whether taken individually or in aggregate and whether judged by any criteria of

[4/] Paragraph 47 of Auditing Standard No. 12 contains a requirement to perform analytical procedures relating to revenue as part of the risk assessment procedures.

size, nature, or circumstances. When there is any uncertainty about whether one or more items is clearly trivial, the matter is not considered trivial.

11. The auditor may designate an amount below which misstatements are clearly trivial and do not need to be accumulated. In such cases, the amount should be set so that any misstatements below that amount would not be material to the financial statements, individually or in combination with other misstatements, considering the possibility of undetected misstatement.

12. The auditor's accumulation of misstatements should include the auditor's best estimate of the total misstatement in the accounts and disclosures that he or she has tested, not just the amount of misstatements specifically identified. This includes misstatements related to accounting estimates, as determined in accordance with paragraph 13 of this standard, and projected misstatements from substantive procedures that involve audit sampling, as determined in accordance with AU sec. 350, *Audit Sampling.*[5/]

13. *Misstatements Relating to Accounting Estimates.* If the auditor concludes that the amount of an accounting estimate included in the financial statements is unreasonable or was not determined in conformity with the relevant requirements of the applicable financial reporting framework, he or she should treat the difference between that estimate and a reasonable estimate determined in conformity with the applicable accounting principles as a misstatement. If a range of reasonable estimates is supported by sufficient appropriate audit evidence and the recorded estimate is outside of the range of reasonable estimates, the auditor should treat the difference between the recorded accounting estimate and the closest reasonable estimate as a misstatement.

> Note: If an accounting estimate is determined in conformity with the relevant requirements of the applicable financial reporting framework and the amount of the estimate is reasonable, a difference between an estimated amount best supported by the audit evidence and the recorded amount of the accounting estimate ordinarily would not be considered to be a misstatement. Paragraph 27 discusses evaluating accounting estimates for bias.

14. *Considerations as the Audit Progresses.* The auditor should determine whether the overall audit strategy and audit plan need to be modified if:

[5/] AU sec. 350.26.

a. The nature of accumulated misstatements and the circumstances of their occurrence indicate that other misstatements might exist that, in combination with accumulated misstatements, could be material; or

b. The aggregate of misstatements accumulated during the audit approaches the materiality level or levels used in planning and performing the audit.[6/]

> Note: When the aggregate of accumulated misstatements approaches the materiality level or levels used in planning and performing the audit, there likely will be greater than an appropriately low level of risk that possible undetected misstatements, when combined with the aggregate of misstatements accumulated during the audit that remain uncorrected, could be material to the financial statements. If the auditor's assessment of this risk is unacceptably high, he or she should perform additional audit procedures or determine that management has adjusted the financial statements so that the risk that the financial statements are materially misstated has been reduced to an appropriately low level.

15. The auditor should communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them.

16. If management has examined an account or a disclosure in response to misstatements detected by the auditor and has made corrections to the account or disclosure, the auditor should evaluate management's work to determine whether the corrections have been recorded properly and whether uncorrected misstatements remain.

17. *Evaluation of the Effect of Uncorrected Misstatements.* The auditor should evaluate whether uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and

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[6/] Auditing Standard No. 11.

disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.[7] (See Appendix B.)

Note: In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[8] As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him …."[9]

Note: As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility[10] that it could lead to a material contingent liability or a material loss of revenue.[11] Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

Note: If the reevaluation of the established materiality level or levels, as set forth in Auditing Standard No. 11,[12] results in a lower

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[7] If the financial statements contain material misstatements, AU sec. 508, *Reports on Audited Financial Statements*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

[8] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

[9] TSC Industries, 426 U.S. at 450.

[10] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

[11] AU sec. 317, *Illegal Acts by Clients.*

[12] Paragraphs 11-12 of Auditing Standard No. 11.

amount for the materiality level or levels, the auditor should take into account that lower materiality level or levels in the evaluation of uncorrected misstatements.

18. The auditor's evaluation of uncorrected misstatements, as described in paragraph 17 of this standard, should include evaluation of the effects of uncorrected misstatements detected in prior years and misstatements detected in the current year that relate to prior years.

19. The auditor cannot assume that an instance of error or fraud is an isolated occurrence. Therefore, the auditor should evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement. This evaluation is important in determining whether the risk assessments remain appropriate, as discussed in paragraph 36 of this standard.

20. *Evaluating Whether Misstatements Might Be Indicative of Fraud.* The auditor should evaluate whether identified misstatements[13/] might be indicative of fraud and, in turn, how they affect the auditor's evaluation of materiality and the related audit responses. As indicated in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, fraud is an intentional act that results in material misstatement of the financial statements.[14/]

21. If the auditor believes that a misstatement is or might be intentional, and if the effect on the financial statements could be material or cannot be readily determined, the auditor should perform procedures to obtain additional audit evidence to determine whether fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements and the auditor's report thereon.

22. For misstatements that the auditor believes are or might be intentional, the auditor should evaluate the implications on the integrity of management or employees and the possible effect on other aspects of the audit. If the misstatement involves higher-level management, it might be indicative of a more pervasive problem, such as an issue with the integrity of management, even if the amount of the misstatement is small. In such circumstances, the auditor should reevaluate the assessment of fraud risk and the effect of that assessment on (a) the nature, timing, and extent of the necessary tests of accounts or disclosures and (b) the assessment of the effectiveness of controls. The auditor

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[13/] Misstatements include omission and presentation of inaccurate or incomplete disclosures.

[14/] AU sec. 316.05.

also should evaluate whether the circumstances or conditions indicate possible collusion involving employees, management, or external parties and, if so, the effect of the collusion on the reliability of evidence obtained.

23. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, he or she also must determine his or her responsibilities under AU secs. 316.79-.82A, AU sec. 317, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1.

Evaluating the Qualitative Aspects of the Company's Accounting Practices

24. When evaluating whether the financial statements as a whole are free of material misstatement, the auditor should evaluate the qualitative aspects of the company's accounting practices, including potential bias in management's judgments about the amounts and disclosures in the financial statements.

25. The following are examples of forms of management bias:

a. The selective correction of misstatements brought to management's attention during the audit (e.g., correcting misstatements that have the effect of increasing reported earnings but not correcting misstatements that have the effect of decreasing reported earnings).

> Note: To evaluate the potential effect of selective correction of misstatements, the auditor should obtain an understanding of the reasons that management decided not to correct misstatements communicated by the auditor in accordance with paragraph 15.

b. The identification by management of additional adjusting entries that offset misstatements accumulated by the auditor. If such adjusting entries are identified, the auditor should perform procedures to determine why the underlying misstatements were not identified previously and evaluate the implications on the integrity of management and the auditor's risk assessments, including fraud risk assessments. The auditor also should perform additional procedures as necessary to address the risk of further undetected misstatement.

c. Bias in the selection and application of accounting principles.[15/]

d. Bias in accounting estimates.[16/]

26. If the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. Also, the auditor should evaluate whether the auditor's risk assessments, including, in particular, the assessment of fraud risks, and the related audit responses remain appropriate.

27. *Evaluating Bias in Accounting Estimates.* The auditor should evaluate whether the difference between estimates best supported by the audit evidence and estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the company's management. If each accounting estimate included in the financial statements was individually reasonable but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase earnings or loss, the auditor should evaluate whether these circumstances indicate potential management bias in the estimates. Bias also can result from the cumulative effect of changes in multiple accounting estimates. If the estimates in the financial statements are grouped at one end of the range of reasonable estimates in the prior year and are grouped at the other end of the range of reasonable estimates in the current year, the auditor should evaluate whether management is using swings in estimates to achieve an expected or desired outcome, e.g., to offset higher or lower than expected earnings.

> Note: AU secs. 316.64-.65 establish requirements regarding performing a retrospective review of accounting estimates and evaluating the potential for fraud risks.

[15/] Paragraph 5.d. of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

[16/] Paragraph 27 of this standard.

Evaluating Conditions Relating to the Assessment of Fraud Risks

28. When evaluating the results of the audit, the auditor should evaluate whether the accumulated results of auditing procedures[17/] and other observations affect the assessment of the fraud risks made throughout the audit and whether the audit procedures need to be modified to respond to those risks. (See Appendix C.)

29. As part of this evaluation, the engagement partner should determine whether there has been appropriate communication with the other engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks.

> Note: To accomplish this communication, the engagement partner might arrange another discussion among the engagement team members about fraud risks. (See paragraphs 49-51 of Auditing Standard No. 12.)

Evaluating the Presentation of the Financial Statements, Including the Disclosures

30. The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

> Note: AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles,* establishes requirements for evaluating the presentation of the financial statements. Auditing Standard No. 6, *Evaluating Consistency of Financial Statements,* establishes requirements regarding evaluating the consistency of the accounting principles used in financial statements.

> Note: The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

[17/] Such auditing procedures include, but are not limited to, procedures in the overall review (paragraph 9 of this standard), the evaluation of identified misstatements (paragraphs 20-23 of this standard), and the evaluation of the qualitative aspects of the company's accounting practices (paragraphs 24-27 of this standard).

31. As part of the evaluation of the presentation of the financial statements, the auditor should evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework. Evaluation of the information disclosed in the financial statements includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

> Note: According to AU sec. 508, if the financial statements, including the accompanying notes, fail to disclose information that is required by the applicable financial reporting framework, the auditor should express a qualified or adverse opinion and should provide the information in the report, if practicable, unless its omission from the report is recognized as appropriate by a specific auditing standard.[18/]

Evaluating the Sufficiency and Appropriateness of Audit Evidence

32. Auditing Standard No. 8, *Audit Risk,* states:

> To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.[19/]

33. As part of evaluating audit results, the auditor must conclude on whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements.

34. Factors that are relevant to the conclusion on whether sufficient appropriate audit evidence has been obtained include the following:

[18/] AU secs. 508.41-.44.

[19/] Paragraph 3 of Auditing Standard No. 8.

a. The significance of uncorrected misstatements and the likelihood of their having a material effect, individually or in combination, on the financial statements, considering the possibility of further undetected misstatement (paragraphs 14 and 17-19 of this standard).

b. The results of audit procedures performed in the audit of financial statements, including whether the evidence obtained supports or contradicts management's assertions and whether such audit procedures identified specific instances of fraud (paragraphs 20-23 and 28-29 of this standard).

c. The auditor's risk assessments (paragraph 36 of this standard).

d. The results of audit procedures performed in the audit of internal control over financial reporting, if the audit is an integrated audit.

e. The appropriateness (i.e., the relevance and reliability) of the audit evidence obtained.[20/]

35. If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion or has substantial doubt about a relevant assertion, the auditor should perform procedures to obtain further audit evidence to address the matter. If the auditor is unable to obtain sufficient appropriate audit evidence to have a reasonable basis to conclude about whether the financial statements as a whole are free of material misstatement, AU sec. 508 indicates that the auditor should express a qualified opinion or a disclaimer of opinion.[21/]

36. *Evaluating the Appropriateness of Risk Assessments.* As part of the evaluation of whether sufficient appropriate audit evidence has been obtained, the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate and whether the audit procedures need to be modified or additional procedures need to be performed as a result of any changes in the risk assessments. For example, the re-evaluation of the auditor's risk assessments could result in the identification of

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[20/] Paragraphs 7-9 of Auditing Standard No. 15, *Audit Evidence,* discuss the relevance and reliability of audit evidence.

[21/] AU sec. 508.22-.34 contains requirements regarding audit scope limitations.

relevant assertions or significant risks that were not identified previously and for which the auditor should perform additional audit procedures.

> Note: Auditing Standard No. 12 establishes requirements on revising the auditor's risk assessment.[22/] Auditing Standard No. 13 discusses the auditor's responsibilities regarding the assessment of control risk and evaluation of control deficiencies in an audit of financial statements.[23/]

Evaluating the Results of the Audit of Internal Control Over Financial Reporting

37. Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* indicates that the auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit, and any identified control deficiencies. Auditing Standard No. 5 describes the auditor's responsibilities regarding evaluating the results of the audit, including evaluating the identified control deficiencies.[24/]

[22/] Paragraph 74 of Auditing Standard No. 12.

[23/] Paragraphs 32-34 of Auditing Standard No. 13.

[24/] Paragraphs 62-70 of Auditing Standard No. 5 discuss evaluating identified control deficiencies, and paragraphs 71-73 of Auditing Standard No. 5 discuss forming an opinion on the effectiveness of internal control over financial reporting.

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Misstatement – A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework.[1/] A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework. Misstatements can arise from error (i.e., unintentional misstatement) or fraud.[2/]

A3. Uncorrected misstatements – Misstatements, other than those that are clearly trivial,[3/] that management has not corrected.

[1/] The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

[2/] Paragraph .02 of AU sec. 316*, Consideration of Fraud in a Financial Statement Audit.*

[3/] Paragraph 10 of this standard states that, "[t]he auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial."

<u>APPENDIX B</u> – Qualitative Factors Related to the Evaluation of the Materiality of Uncorrected Misstatements

B1. Paragraph 17 of this standard states:

> The auditor should evaluate whether uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.[1/]
>
> > Note: In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[2/] As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him …."[3/]
> >
> > Note: As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility[4/]

[1/] If the financial statements contain material misstatements, AU sec. 508, *Reports on Audited Financial Statements*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

[2/] <u>TSC Industries v. Northway, Inc.</u>, 426 U.S. 438, 449 (1976). <u>See also</u> <u>Basic, Inc. v. Levinson</u>, 485 U.S. 224 (1988).

[3/] <u>TSC Industries</u>, 426 U.S. at 450.

[4/] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or that it could lead to a material contingent liability or a material loss of revenue.[5/] Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

B2. Qualitative factors to consider in the auditor's evaluation of the materiality of uncorrected misstatements, if relevant, include the following:

a. The potential effect of the misstatement on trends, especially trends in profitability.

b. A misstatement that changes a loss into income or vice versa.

c. The effect of the misstatement on segment information, for example, the significance of the matter to a particular segment important to the future profitability of the company, the pervasiveness of the matter on the segment information, and the impact of the matter on trends in segment information, all in relation to the financial statements taken as a whole.

d. The potential effect of the misstatement on the company's compliance with loan covenants, other contractual agreements, and regulatory provisions.

e. The existence of statutory or regulatory reporting requirements that affect materiality thresholds.

f. A misstatement that has the effect of increasing management's compensation, for example, by satisfying the requirements for the award of bonuses or other forms of incentive compensation.

g. The sensitivity of the circumstances surrounding the misstatement, for example, the implications of misstatements involving fraud and possible illegal acts, violations of contractual provisions, and conflicts of interest.

"probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

[5/] AU sec. 317, *Illegal Acts by Clients.*

h. The significance of the financial statement element affected by the misstatement, for example, a misstatement affecting recurring earnings as contrasted to one involving a non-recurring charge or credit, such as an extraordinary item.

i. The effects of misclassifications, for example, misclassification between operating and non-operating income or recurring and non-recurring income items.

j. The significance of the misstatement or disclosures relative to known user needs, for example:

- The significance of earnings and earnings per share to public company investors.

- The magnifying effects of a misstatement on the calculation of purchase price in a transfer of interests (buy/sell agreement).

- The effect of misstatements of earnings when contrasted with expectations.

k. The definitive character of the misstatement, for example, the precision of an error that is objectively determinable as contrasted with a misstatement that unavoidably involves a degree of subjectivity through estimation, allocation, or uncertainty.

l. The motivation of management with respect to the misstatement, for example, (i) an indication of a possible pattern of bias by management when developing and accumulating accounting estimates or (ii) a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process.

m. The existence of offsetting effects of individually significant but different misstatements.

n. The likelihood that a misstatement that is currently immaterial may have a material effect in future periods because of a cumulative effect, for example, that builds over several periods.

o. The cost of making the correction − it may not be cost-beneficial for the client to develop a system to calculate a basis to record the effect of an immaterial misstatement. On the other hand, if management appears to have developed a system to calculate an amount that represents an immaterial misstatement, it may reflect a motivation of management as noted in paragraph B2.l above.

p. The risk that possible additional undetected misstatements would affect the auditor's evaluation.

APPENDIX C – Matters That Might Affect the Assessment of Fraud Risks

C1. If the following matters are identified during the audit, the auditor should take into account these matters in the evaluation of the assessment of fraud risks, as discussed in paragraph 28 of this standard:

a. Discrepancies in the accounting records, including:

(1) Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or company policy.

(2) Unsupported or unauthorized balances or transactions.

(3) Last-minute adjustments that significantly affect financial results.

(4) Evidence of employees' access to systems and records that is inconsistent with the access that is necessary to perform their authorized duties.

(5) Tips or complaints to the auditor about alleged fraud.

b. Conflicting or missing evidence, including:

(1) Missing documents.

(2) Documents that appear to have been altered.[1/]

(3) Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.

(4) Significant unexplained items in reconciliations.

(5) Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.

(6) Unusual discrepancies between the company's records and confirmation responses.

[1/] Paragraph 9 of Auditing Standard No. 15, *Audit Evidence.*

(7) Missing inventory or physical assets of significant magnitude.

(8) Unavailable or missing electronic evidence that is inconsistent with the company's record retention practices or policies.

(9) Inability to produce evidence of key systems development and program change testing and implementation activities for current year system changes and deployments.

(10) Unusual balance sheet changes or changes in trends or important financial statement ratios or relationships, e.g., receivables growing faster than revenues.

(11) Large numbers of credit entries and other adjustments made to accounts receivable records.

(12) Unexplained or inadequately explained differences between the accounts receivable subsidiary ledger and the general ledger control account, or between the customer statement and the accounts receivable subsidiary ledger.

(13) Missing or nonexistent cancelled checks in circumstances in which cancelled checks are ordinarily returned to the company with the bank statement.

(14) Fewer responses to confirmation requests than anticipated or a greater number of responses than anticipated.

c. Problematic or unusual relationships between the auditor and management, including:

(1) Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought, including:[2/]

[2/] Denial of access to information might constitute a limitation on the scope of the audit that requires the auditor to qualify or disclaim an opinion. (See Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and AU sec. 508, *Reports on Audited Financial Statements.*)

a. Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.

b. Denial of access to key information technology operations staff and facilities, including security, operations, and systems development.

(2) Undue time pressures imposed by management to resolve complex or contentious issues.

(3) Management pressure on engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.

(4) Unusual delays by management in providing requested information.

(5) Management's unwillingness to add or revise disclosures in the financial statements to make them more complete and transparent.

(6) Management's unwillingness to appropriately address significant deficiencies in internal control on a timely basis.

d. Other matters, including:

(1) Objections by management to the auditor meeting privately with the audit committee.

(2) Accounting policies that appear inconsistent with industry practices that are widely recognized and prevalent.

(3) Frequent changes in accounting estimates that do not appear to result from changing circumstances.

(4) Tolerance of violations of the company's code of conduct.

Auditing Standard No. 15

Audit Evidence

Introduction

1. This standard explains what constitutes audit evidence and establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.

2. Audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and information that contradicts such assertions.

Objective

3. The objective of the auditor is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report.[1/]

Sufficient Appropriate Audit Evidence

4. The auditor must plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion.

5. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the following:

- *Risk of material misstatement (in the audit of financial statements) or the risk associated with the control (in the audit of internal control over financial reporting).* As the risk increases, the amount of evidence that the auditor should obtain also increases. For

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[1/] Auditing Standard No. 14, *Evaluating Audit Results,* establishes requirements regarding evaluating whether sufficient appropriate evidence has been obtained. Auditing Standard No. 3, *Audit Documentation,* establishes requirements regarding documenting the procedures performed, evidence obtained, and conclusions reached in an audit.

example, ordinarily more evidence is needed to respond to significant risks.[2/]

- *Quality of the audit evidence obtained.* As the quality of the evidence increases, the need for additional corroborating evidence decreases. Obtaining more of the same type of audit evidence, however, cannot compensate for the poor quality of that evidence.

6. Appropriateness is the measure of the quality of audit evidence, i.e., its relevance and reliability. To be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based.

Relevance and Reliability

7. *Relevance.* The relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The relevance of audit evidence depends on:

a. The design of the audit procedure used to test the assertion or control, in particular whether it is designed to (1) test the assertion or control directly and (2) test for understatement or overstatement; and

b. The timing of the audit procedure used to test the assertion or control.

8. *Reliability.* The reliability of evidence depends on the nature and source of the evidence and the circumstances under which it is obtained. For example, in general:

- Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources.

- The reliability of information generated internally by the company is increased when the company's controls over that information are effective.

- Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.

[2/] Paragraph A5 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

- Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized, or otherwise converted into electronic form, the reliability of which depends on the controls over the conversion and maintenance of those documents.

9. The auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should evaluate the effect, if any, on the other aspects of the audit.

Using Information Produced by the Company

10. When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to:[3/]

- Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and

- Evaluate whether the information is sufficiently precise and detailed for purposes of the audit.

Financial Statement Assertions

11. In representing that the financial statements are presented fairly in conformity with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of financial statements and related disclosures. Those assertions can be classified into the following categories:

[3/] When using the work of a specialist engaged or employed by management, see AU sec. 336, *Using the Work of a Specialist.* When using information produced by a service organization or a service auditor's report as audit evidence, see AU sec. 324, *Service Organizations*, and for integrated audits, see Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

- *Existence or occurrence* – Assets or liabilities of the company exist at a given date, and recorded transactions have occurred during a given period.

- *Completeness* – All transactions and accounts that should be presented in the financial statements are so included.

- *Valuation or allocation* – Asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts.

- *Rights and obligations* – The company holds or controls rights to the assets, and liabilities are obligations of the company at a given date.

- *Presentation and disclosure* – The components of the financial statements are properly classified, described, and disclosed.

12. The auditor may base his or her work on financial statement assertions that differ from those in this standard if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement in each significant account and disclosure that has a reasonable possibility[4/] of containing misstatements that would cause the financial statements to be materially misstated, individually or in combination with other misstatements.[5/]

Audit Procedures for Obtaining Audit Evidence

13. Audit procedures can be classified into the following categories:

a. Risk assessment procedures,[6/] and

[4/] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

[5/] For an integrated audit, also see paragraph 28 of Auditing Standard No. 5.

[6/] Auditing Standard No. 12.

b. Further audit procedures,[7/] which consist of:

(1) Tests of controls, and

(2) Substantive procedures, including tests of details and substantive analytical procedures.

14. Paragraphs 15-21 of this standard describe specific audit procedures. The purpose of an audit procedure determines whether it is a risk assessment procedure, test of controls, or substantive procedure.

Inspection

15. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or physically examining an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorization.

Observation

16. Observation consists of looking at a process or procedure being performed by others, e.g., the auditor's observation of inventory counting by the company's personnel or the performance of control activities. Observation can provide audit evidence about the performance of a process or procedure, but the evidence is limited to the point in time at which the observation takes place and also is limited by the fact that the act of being observed may affect how the process or procedure is performed.[8/]

Inquiry

17. Inquiry consists of seeking information from knowledgeable persons in financial or nonfinancial roles within the company or outside the company. Inquiry may be performed throughout the audit in addition to other audit procedures.

[7/] Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

[8/] AU sec. 331, *Inventories,* establishes requirements regarding observation of the counting of inventory.

Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.[9/]

> Note: Inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.

Confirmation

18. A confirmation response represents a particular form of audit evidence obtained by the auditor from a third party in accordance with PCAOB standards.[10/]

Recalculation

19. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Reperformance

20. Reperformance involves the independent execution of procedures or controls that were originally performed by company personnel.

Analytical Procedures

21. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass the investigation of significant differences from expected amounts.[11/]

[9/] AU sec. 333, *Management Representations,* establishes requirements regarding written management representations, including confirmation of management responses to oral inquiries.

[10/] AU sec. 330, *The Confirmation Process.*

[11/] AU sec. 329, *Substantive Analytical Procedures,* establishes requirements on performing analytical procedures as substantive procedures.

Selecting Items for Testing to Obtain Audit Evidence

22. Designing substantive tests of details and tests of controls includes determining the means of selecting items for testing from among the items included in an account or the occurrences of a control. The auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. The alternative means of selecting items for testing are:

- Selecting all items;
- Selecting specific items; and
- Audit sampling.

23. The particular means or combination of means of selecting items for testing that is appropriate depends on the nature of the audit procedure, the characteristics of the control or the items in the account being tested, and the evidence necessary to meet the objective of the audit procedure.

Selecting All Items

24. Selecting all items (100 percent examination) refers to testing the entire population of items in an account or the entire population of occurrences of a control (or an entire stratum within one of those populations). The following are examples of situations in which 100 percent examination might be applied:

- The population constitutes a small number of large value items;
- The audit procedure is designed to respond to a significant risk, and other means of selecting items for testing do not provide sufficient appropriate audit evidence; and
- The audit procedure can be automated effectively and applied to the entire population.

Selecting Specific Items

25. Selecting specific items refers to testing all of the items in a population that have a specified characteristic, such as:

- *Key items.* The auditor may decide to select specific items within a population because they are important to accomplishing the objective of the audit procedure or exhibit some other characteristic, e.g., items that are suspicious, unusual, or particularly risk-prone or items that have a history of error.

- *All items over a certain amount.* The auditor may decide to examine items whose recorded values exceed a certain amount to verify a large proportion of the total amount of the items included in an account.

26. The auditor also might select specific items to obtain an understanding about matters such as the nature of the company or the nature of transactions.

27. The application of audit procedures to items that are selected as described in paragraphs 25-26 of this standard does not constitute audit sampling, and the results of those audit procedures cannot be projected to the entire population.[12/]

Audit Sampling

28. Audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.[13/]

Inconsistency in, or Doubts about the Reliability of, Audit Evidence

29. If audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

[12/] If misstatements are identified in the selected items, see paragraphs 12-13 and paragraphs 17-19 of Auditing Standard No. 14.

[13/] AU sec. 350, *Audit Sampling,* establishes requirements regarding audit sampling.

Amendment to PCAOB Interim Auditing Standards

Auditing Standards

AU sec. 110, "Responsibilities and Functions of the Independent Auditor"

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures" section 110, "Responsibilities and Functions of the Independent Auditor" (AU sec. 110, "Responsibilities and Functions of the Independent Auditor"), as amended, is amended as follows:

Within footnote 1 to paragraph .02, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit.*

AU sec. 150, "Generally Accepted Auditing Standards"

SAS No. 95, "Generally Accepted Auditing Standards" (AU sec. 150, "Generally Accepted Auditing Standards"), as amended, is amended as follows:

a. Within paragraph .02, in the third standard of field work, the word "competent" is replaced with the word "appropriate."

b. Footnote 2 to paragraph .04 is deleted.

AU sec. 210, "Training and Proficiency of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 210, "Training and Proficiency of the Independent Auditor" (AU sec. 210, "Training and Proficiency of the Independent Auditor "), as amended, is amended as follows:

The last sentence of paragraph .03 is replaced with:

The engagement partner must exercise seasoned judgment in the varying degrees of his supervision and review of the work done and judgments exercised by his subordinates, who in turn must meet the responsibilities attaching to the varying gradations and functions of their work.

AU sec. 230, "Due Professional Care in the Performance of Work"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 230, "Due Professional Care in the Performance of Work" (AU sec. 230, "Due Professional Care in the Performance of Work"), as amended, is amended as follows:

a. The second and third sentences of paragraph .06 are replaced with:

   The engagement partner should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client. The engagement partner is responsible for the assignment of tasks to, and supervision of, the members of the engagement team.[fn4]

b. Footnote 3 to paragraph .06 is deleted.

c. Within footnote 4 to paragraph .06, the phrase "See section 311.11" is replaced with, "See Auditing Standard No. 10, *Supervision of the Audit Engagement*."

d. Footnote 6 to paragraph .11 is deleted.

e. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

f. At the end of the fifth sentence of paragraph .12, the following parenthetical is added: "(See paragraph 9 of Auditing Standard No. 15, *Audit Evidence*.)"

AU sec. 310, "Appointment of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 310, "Appointment of the Independent Auditor" (AU sec. 310, "Appointment of the Independent Auditor"), as amended, is amended as follows:

a. Within footnote ** to the title of the standard, the sentence "(See section 313.)" is deleted.

b. Paragraph .02 is replaced with:

   Audit planning is discussed in Auditing Standard No. 9, *Audit Planning*, and supervision of engagement team members is discussed in Auditing Standard No. 10, *Supervision of the Audit Engagement.*

c. In paragraph .03, the sentence "(See section 313)" is deleted.

d. Within footnote 3 to paragraph .06, the reference to Section 312, *Audit Risk and Materiality in Conducting an Audit,* paragraph .04, is replaced with a reference to Paragraph A2 of Auditing Standard No. 14, *Evaluating Audit Results.*

AU sec. 311, "Planning and Supervision"

SAS No. 22, "Planning and Supervision" (AU sec. 311, "Planning and Supervision"), as amended, is superseded.

AU sec. 9311, "Planning and Supervision: Auditing Interpretations of Section 311"

AU sec. 9311, "Planning and Supervision: Auditing Interpretations of Section 311", as amended, is superseded.

AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"

SAS No. 47, "Audit Risk and Materiality in Conducting an Audit" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), as amended, is superseded.

AU sec. 9312, "Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312"

AU sec. 9312, "Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312" is superseded.

AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"

SAS No. 45, "Omnibus Statement on Auditing Standards – 1983" (AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"), as amended, is superseded.

AU sec. 315, "Communications Between Predecessor and Successor Auditors"

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows:

a. In the first sentence of paragraph .12, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .18, the word "competent" is replaced with the word "appropriate."

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

a. The second sentence of paragraph .01 is replaced with:

   This section establishes requirements and provides direction relevant to fulfilling that responsibility, as it relates to fraud, in an audit of financial statements. [fn 2]

b. In footnote 1 to paragraph .01, delete the following information: (see section 312, *Audit Risk and Materiality in Conducting an Audit*," and the closing parenthesis at the end of that sentence.

c. Footnote 2 to paragraph .01 is replaced with:

   For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

d. The following paragraph .01A is added:

   Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements. Auditing Standard No. 13, *The Auditor's Responses* to *the Risks of Material Misstatement,* establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement. Auditing Standard

No. 14, *Evaluating Audit Results,* establishes requirements regarding the auditor's evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.

e. In paragraph .02:

- The third through the sixth bullet points are deleted.
- The seventh bullet point is replaced with:

  Responding to fraud risks. This section discusses certain responses to fraud risks involving the nature, timing, and extent of audit procedures, including:

  - o Responses to assessed fraud risks relating to fraudulent financial reporting and misappropriation of assets (see paragraphs .52 through .56).
  - o Responses to specifically address the fraud risks arising from management override of internal controls (see paragraphs .57 through .67).

- The eighth bullet point is deleted.

f. Paragraph .03 is deleted.

g. Footnote 5 to paragraph .06 is replaced with:

The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

h. In the third sentence of paragraph .13, the term "the risk of material misstatement due to fraud" is replaced with the term "fraud risks."

i. Paragraphs .14 through .45 are deleted, along with the preceding heading, "Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud."

j. Footnotes 8 through 19 related to paragraphs .14 through .45 are deleted.

k. Paragraphs .46 through .50 are deleted. The heading preceding paragraph .46, "Responding to the Results of the Assessment," is replaced with the heading "Responding to Assessed Fraud Risks."

l. Paragraph .51 is deleted. The heading preceding paragraph .51, "Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed to Address the Identified Risks," is replaced with the heading "Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed."

m. Paragraph .52 is replaced with:

Paragraph 8 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement,* states that "[t]he auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement due to error or fraud for each relevant assertion of each significant account and disclosure." Paragraph 12 of Auditing Standard No. 13 states that "the audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected."

> Note: Paragraph 71.b. of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, states that a fraud risk is a significant risk. Accordingly, the requirement for responding to significant risks also applies to fraud risks.

n. In paragraph .53:

- The first sentence is replaced with:

  The following are examples of responses to assessed fraud risks involving the nature, timing, and extent of audit procedures:

- The fifth bullet point is replaced with:

  Interviewing personnel involved in activities in areas in which a fraud risk has been identified to obtain their insights about the risk and how controls address the risk. (See paragraph 54 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*)

- In the sixth bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

o. Footnote 20 to paragraph .53 is replaced with:

AU sec. 329, *Substantive Analytical Procedures*, establishes requirements regarding performing analytical procedures as substantive tests.

p. The heading preceding paragraph .54, "Additional Examples of Responses to Identified Risks of Misstatements Arising From Fraudulent Financial Reporting," is replaced with the heading "Additional Examples of Audit Procedures Performed to Respond to Assessed Fraud Risks Relating to Fraudulent Financial Reporting."

q. The first sentence in paragraph .54 is replaced with:

The following are additional examples of audit procedures that might be performed in response to assessed fraud risks relating to fraudulent financial reporting:

r. In paragraph .54:

- In the last sentence of the first bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- In the first sentence of the second bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- In the first sentence of the third bullet point and the accompanying paragraph to the third bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

s. Footnotes 21 and 22 to paragraph .54 are amended as follows:

- The text of footnote 21 is replaced with "AU sec. 330, *The Confirmation Process*, establishes requirements regarding the confirmation process in audits of financial statements."

- The text of footnote 22 is replaced with "AU sec. 336, *Using the Work of a Specialist*, establishes requirements for an auditor who uses the work of a specialist in performing an audit of financial statements."

t. The heading preceding paragraph .55, "Examples of Responses to Identified Risks of Misstatements Arising From Misappropriations of Assets," is replaced with the heading "Examples of Audit Procedures Performed to Respond to Fraud Risks Relating to Misappropriations of Assets."

u. In the first sentence of paragraph .55, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

v. In paragraph .56:

- The first and second sentences are replaced with:

  The audit procedures performed in response to a fraud risk relating to misappropriation of assets usually will be directed toward certain account balances. Although some of the audit procedures noted in paragraphs .53 and .54 and in paragraphs 8 through 15 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement,* may apply in such circumstances, such as the procedures directed at inventory quantities, the scope of the work should be linked to the specific information about the misappropriation risk that has been identified.

- In the third sentence, the words "design and" are added before the words "operating effectiveness."

w. The heading preceding paragraph .57, "Responses to Further Address the Risk of Management Override of Controls," is replaced with the heading "Audit Procedures Performed to Specifically Address the Risk of Management Override of Controls."

x. The third sentence of paragraph .57 is replaced with:

Accordingly, as part of the auditor's responses that address fraud risks, the procedures described in paragraphs .58 through .67 should be performed to specifically address the risk of management override of controls.

y. Footnote 23 to paragraph .58 is replaced with:

See paragraphs 28 through 32 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

z. In paragraph .61:

- In the first sentence of the first bullet point, the term "the risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- In the second bullet point, the last two sentences are replaced with the following:

  Effective controls over the preparation and posting of journal entries and adjustments may affect the extent of substantive testing necessary, provided that the auditor has tested the controls. However, even though controls might be implemented and operating effectively, the auditor's substantive procedures for testing journal entries and other adjustments should include the identification and substantive testing of specific items.

- In item (f) of the fifth bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- The last sentence of the fifth bullet point is replaced with:

  In audits of entities that have multiple locations or business units, the auditor should determine whether to select journal entries from locations based on factors set forth in paragraphs 11 through 14 of Auditing Standard No. 9, *Audit Planning*.

aa. The last sentence of paragraph .63 is replaced with:

Paragraphs 24 through 27 of Auditing Standard No. 14, *Evaluating Audit Results,* discuss the auditor's responsibilities for assessing bias in accounting estimates and the effect of bias on the financial statements.

bb. Paragraphs .68 through .78 are deleted, along with the preceding heading "Evaluating Audit Evidence."

cc. Footnotes 26 through 36 related to paragraphs .68 through .78 are deleted.

dd. In the first sentence of paragraph .80, the term "risks of material misstatement due to fraud" is replaced with the term "fraud risks."

ee. The last sentence of paragraph .80 is replaced with:

The auditor also should evaluate whether the absence of or deficiencies in controls that address fraud risks or otherwise help prevent, deter, and detect fraud (see paragraphs 72-73 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*) represent significant deficiencies or material weaknesses that should be communicated to senior management and the audit committee.

ff. The first sentence of paragraph .81 is replaced with:

The auditor also should consider communicating other fraud risks, if any, identified by the auditor.

gg. In paragraph .83:

- The reference in the first bullet point to paragraphs .14 through .17 is replaced with a reference to paragraphs 52 and 53 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

- The term "risks of material misstatement due to fraud" in the first sentence of the second bullet point is replaced with the term "fraud risks." The reference in the second bullet point to paragraphs .19 through .34 is replaced with references to paragraph 47, paragraphs 56 through 58, and paragraphs 65 through 69 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

- The third bullet point is replaced with:

  The fraud risks that were identified at the financial statement and assertion levels (see paragraphs 59 through 69 of

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*), and the linkage of those risks to the auditor's response (see paragraphs 5 through 15 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*).

- Within the fourth bullet point, the term "risk of material misstatement due to fraud" in the first sentence is replaced with the term "fraud risk," and the reference to paragraph .41 is replaced with a reference to paragraph 68 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

- The fifth bullet point is replaced with:

  The results of the procedures performed to address the assessed fraud risks, including those procedures performed to further address the risk of management override of controls (See paragraph 15 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatements.*)

- The reference in the sixth bullet point to paragraphs .68 through .73 is replaced with a reference to paragraphs 5 through 9 of Auditing Standard No. 14, *Evaluating Audit Results*.

hh. Paragraph .84 and the heading preceding this paragraph, "Effective Date," are deleted.

ii. The first sentence of paragraph .85 is replaced with:

This appendix contains examples of risk factors discussed in paragraphs 65 through 69 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

AU sec. 317, "Illegal Acts by Clients"

SAS No. 54, "Illegal Acts by Clients" (AU sec. 317, "Illegal Acts by Clients") is amended as follows:

a. The last sentence of paragraph .13 is replaced with:

For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

b. In paragraph .19, the word "competent" is replaced with the word "appropriate."

AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"

SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), as amended, is superseded.

AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"

SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), as amended, is amended as follows:

a. In the first sentence of paragraph .02, the word "competent" is replaced with the word "appropriate."

b. Footnote 3 to paragraph .04, is replaced with:

   Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, describes the procedures the auditor performs to obtain an understanding of internal control over financial reporting.

c. In the first sentence of paragraph .18, the word "competent" is replaced with the word "appropriate."

d. Within footnote 5 to paragraph .18, the reference to section 326, *Evidential Matter*, paragraph .19c. is replaced with a reference to paragraph 8 of Auditing Standard No. 15, *Audit Evidence*.

e. Within footnote 8 to paragraph .27, the reference to section 311, *Planning and Supervision*, paragraphs .11 through .14 is replaced with a reference to Auditing Standard No. 10, *Supervision of the Audit Engagement*.

AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations" (AU sec. 324, "Service Organizations"), as amended, is amended as follows:

a. In the first sentence of paragraph .07, the reference to Section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

b. In the first sentence of paragraph .16, the reference to section 319.90 through .99 is replaced with a reference to paragraph 18 and paragraphs 29 through 31 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

c. In the second sentence of paragraph .23, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit,* is replaced with a reference to Auditing Standard No. 14, *Evaluating Audit Results*.

AU sec. 326, "Evidential Matter"

SAS No. 31, "Evidential Matter" (AU sec. 326, "Evidential Matter"), as amended, is superseded.

AU sec. 9326, "Evidential Matter: Auditing Interpretations of Section 326"

AU sec. 9326, "Evidential Matter: Auditing Interpretations of Section 326," as amended, is amended as follows:

a. Paragraphs .01-.05 are deleted, along with the preceding heading "1. Evidential Matter for an Audit of Interim Financial Statements."

b. The reference in paragraph .10 to Section 326, *Evidential Matter*, paragraph .25, is replaced with a reference to Paragraph 35 of Auditing Standard No. 14, *Evaluating Audit Results*.

c. In the first and second sentences of paragraph .10, the word "competent" is replaced with the word "appropriate."

d. In the second sentence of paragraph .12, the word "competent" is replaced with the word "appropriate."

e. The last two sentences of paragraph .12 are deleted.

f. In the first sentence of paragraph .13, the word "competent" is replaced with the word "appropriate."

g. In paragraph .17, the word "competent" is replaced with the word "appropriate."

h. In the second sentence of paragraph .21, the word "competent" is replaced with the word "appropriate."

i. In the fourth sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."

j. In paragraph .23, the word "competent" is replaced with the word "appropriate."

k. Paragraphs .24-.41 are deleted, along with the headings "3. The Auditor's Consideration of the Completeness Assertion" and "4. Applying Auditing Procedures to Segment Disclosures in Financial Statements."

AU sec. 328, "Auditing Fair Value Measurements and Disclosures"

SAS No. 101, "Auditing Fair Value Measurements and Disclosures" (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), as amended, is amended as follows:

a. In the first sentence of paragraph .03, the word "competent" is replaced with the word "appropriate."

b. The phrase in paragraph .11 "Section 319, *Consideration of Internal Control in a Financial Statement Audit*, as amended," is replaced with "Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*,"

c. The reference in paragraph .14 to Section 319 is replaced with a reference to Paragraph A5, second note of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

d. In the second sentence of paragraph .14, the reference "(see section 316, *Consideration of Fraud in a Financial Statement Audit*" is deleted.

e. Within paragraph .25, in the second sentence of the second bullet point and in the first sentence in the third bullet point, the word "competent" is replaced with the word "appropriate."

f. In the second sentence of paragraph .32, the word "competent" is replaced with the word "appropriate."

g. In the first sentence of paragraph .42, the word "competent" is replaced with the word "appropriate."

h. In footnote 8 to paragraph .43, the reference to section 431, *Adequacy of Disclosure in Financial Statements,* is replaced with a reference to "paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results."*

i. In the second sentence of paragraph .44, the word "competent" is replaced with the word "appropriate."

j. The reference in paragraph .47 to section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraphs .36 through .41, is replaced with a reference to paragraphs 12 through 18 and 24 through 27 of Auditing Standard No. 14, *Evaluating Audit Results*.

AU sec. 329, "Analytical Procedures"

SAS No. 56, "Analytical Procedures" (AU sec. 329, "Analytical Procedures"), as amended, is amended as follows:

a. The title of the standard, "Analytical Procedures," is replaced with the title, "Substantive Analytical Procedures."

b. The text of paragraph .01 is replaced with:

This section establishes requirements regarding the use of substantive analytical procedures in an audit.

> Note: Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* establishes requirements regarding performing analytical procedures as a risk assessment procedure in identifying and assessing risks of material misstatement.

> Note: Auditing Standard No. 14, *Evaluating Audit Results,* establishes requirements regarding performing analytical procedures as part of the overall review stage of the audit.

c. The last sentence of paragraph .03 is deleted.

d. The text of paragraph .04 is replaced with:

Analytical procedures are used as a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions. In some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

e. Paragraphs .06-.08 and the preceding heading, "Analytical Procedures in Planning the Audit," are deleted.

f. At the end of paragraph .09, the following new sentence is added:

(See paragraph 11 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*)

g. Within footnote 1 to paragraph .09, the reference to section 326, *Evidential Matter,* is replaced with a reference to Auditing Standard No. 15, *Audit Evidence.*

h. Footnote 2 to paragraph .20 is deleted.

i. In paragraph .21:

- In the fourth sentence, the word "likely" is deleted.
- The reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, is replaced with a reference to Auditing Standard No. 14, *Evaluating Audit Results*.

j. Footnote 3 to paragraph .21 is deleted.

k. Paragraph .23 and the preceding heading, "Analytical Procedures Used in the Overall Review," and paragraph .24 and the preceding heading, "Effective Date," are deleted.

AU sec. 330, "The Confirmation Process"

SAS No. 67, "The Confirmation Process" (AU sec. 330, "The Confirmation Process"), is amended as follows:

a. The references in paragraph .02 to section 312, *Audit Risk and Materiality in Conducting an Audit*, and section 313, *Substantive Tests Prior to the Balance-Sheet Date*, are replaced with a reference to Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

b. The reference in paragraph .05 to Section 312 is replaced with a reference to Auditing Standard No. 8, *Audit Risk*.

c. The second sentence of paragraph .06 is replaced with:

   See paragraph 8 of Auditing Standard No. 15, *Audit Evidence*, which discusses the reliability of audit evidence.

d. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

e. In the third sentence of paragraph .11, the reference to Section 326 is replaced with a reference to Auditing Standard No. 15, *Audit Evidence*.

f. In the first sentence of paragraph .24, the word "competence" is replaced with the word "appropriateness."

g. In the last sentence of paragraph .27, the word "competent" is replaced with the word "appropriate."

AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"

SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investment in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), as amended, is amended as follows:

a. The reference in paragraph .01 to section 326, *Evidential Matter*, paragraphs .03 – .08, is replaced with a reference to paragraphs 11 and 12 of Auditing Standard No. 15, *Audit Evidence*.

b. Paragraph .06 is replaced with:

Auditing Standard No. 9, *Audit Planning,* discusses the auditor's responsibilities for consideration of the use of persons with specialized skill or knowledge. Auditing Standard No. 10, *Supervision of the Audit Engagement,* discusses the auditor's responsibilities for supervision of specialists who are employed by the auditor. AU sec. 336, *Using the Work of a Specialist,* discusses the auditor's responsibilities for using the work of a specialist engaged by the auditor.

c. The first and second sentences of paragraph .07 are deleted. The third sentence is replaced with:

The auditor should design and perform audit procedures regarding relevant assertions of derivatives and investments in securities that are based on and that address the risks of material misstatement in those assertions.

d. The reference in paragraph .09 to Section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

e. The fourth sentence of paragraph .11 is replaced with "Paragraphs 28 through 32 and B1 through B6 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* discuss the information system, including related business processes, relevant to financial reporting."

f. In paragraph .15, the reference to section 319 is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

g. The last sentence of paragraph .35 is replaced with:

In addition, paragraphs 24 through 27 of Auditing Standard No. 14, *Evaluating Audit Results*, describe the auditor's responsibilities for assessing bias in accounting estimates.

h. In paragraph .43, subparagraph a., the word "competent" is replaced with the word "appropriate."

i. In paragraph .51, the last sentence is replaced with:

(See paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.)*

j. In paragraph .57, subparagraph c., the word "competent" is replaced with the word "appropriate."

<u>AU sec. 333, "Management Representations"</u>

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows:

a. Footnote 4 to paragraph .06 is replaced with:

Auditing Standard No. 14, *Evaluating Audit Results*, indicates that a misstatement can arise from error or fraud and also discusses the auditor's responsibilities for evaluating accumulated misstatements.

b. Within footnote 6 to paragraph .06, the reference to Section 312 is replaced with a reference to Paragraph 11 of Auditing Standard No. 14, *Evaluating Audit Results*.

c. Within footnote 7 to paragraph .06, the reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, paragraphs .38 through .40, is replaced with a reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, paragraphs .79 through .82.

<u>AU sec. 334, "Related Parties"</u>

SAS No. 45, "Related Parties" (AU sec. 334 "Related Parties"), is amended as follows:

a. In the second sentence of paragraph .09, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

c. In footnote 8 to paragraph .11, the reference to section 431, *Adequacy of Disclosure in Financial Statements,* is replaced with a reference to paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.*

<u>AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334"</u>

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334," is amended as follows:

Within footnote 4 to paragraph .17, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Auditing Standard No. 8, *Audit Risk*.

<u>AU sec. 336, "Using the Work of a Specialist"</u>

SAS No. 73, "Using the Work of a Specialist" (AU sec. 336, "Using the Work of a Specialist"), is amended as follows:

a. Footnote 1 to paragraph .01 is replaced with the following:

   Because income taxes and information technology are specialized areas of accounting and auditing, this section does not apply to situations in which an income tax specialist or information technology specialist participates in the audit. Auditing Standard No. 10, *Supervision of the Audit Engagement,* applies in those situations.

b. Paragraph .05 is replaced with the following:

   This section does not apply to situations in which a specialist employed by the auditor's firm participates in the audit. Auditing Standard No. 10, *Supervision of the Audit Engagement,* applies in those situations.

c. In the last sentence of paragraph .06, the word "competent" is replaced with the word "appropriate."

d. In the first and last sentences of paragraph .13, the word "competent" is replaced with the word "appropriate."

<u>AU sec. 9336, "Using the Work of a Specialist: Auditing Interpretations of Section 336"</u>

AU sec. 9336, "Using the Work of a Specialist: Auditing Interpretations of Section 336," is amended as follows:

a. In the second sentence of paragraph .04, the word "competent" is replaced with the word "appropriate."

b. In paragraph .05, the word "competent" is replaced with the word "appropriate."

c. In the second sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

d. The penultimate sentence of paragraph .15, is replaced with:

Paragraph 6 of Auditing Standard No. 15, *Audit Evidence*, states, "[t]o be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based."

AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"

SAS No. 59, "The Auditor's Consideration of an Entity's Ability to Continue as Going Concern" (AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"), as amended, is amended as follows:

The reference in paragraph .02 to section 326, *Evidential Matter*, is replaced with a reference to Auditing Standard No. 15, *Audit Evidence*.

AU sec. 342, "Auditing Accounting Estimates"

SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), as amended, is amended as follows:

a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .07, the word "competent" is replaced with the word "appropriate."

c. The text of footnote 3 to paragraph .07 is replaced with:

See paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.*

d. The reference in paragraph .08 subparagraph b.1. to section 311, *Planning and Supervision*, is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

e. Paragraph .14, is replaced with:

> Paragraphs 24 through 27 of Auditing Standard No. 14, *Evaluating Audit Results*, discuss the auditor's responsibilities for assessing bias and evaluating accounting estimates in relationship to the financial statements taken as a whole.

<u>AU sec. 9342, "Auditing Accounting Estimates: Auditing Interpretations of Section 342"</u>

AU sec. 9342, "Auditing Accounting Estimates: Auditing Interpretations of Section 342," is amended as follows:

> In the second sentence of paragraph .02, the word "competent" is replaced with the word "appropriate."

<u>AU sec. 350, "Audit Sampling"</u>

SAS No. 39, "Audit Sampling" (AU sec. 350, "Audit Sampling"), as amended, is amended as follows:

a. Within footnote 2 to paragraph .02, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Auditing Standard No. 14, *Evaluating Audit Results*.

b. The last sentence of paragraph .03 is replaced with:

> Either approach to audit sampling can provide sufficient evidential matter when applied properly. This section applies to both nonstatistical and statistical sampling.

c. Paragraph .04 is deleted.

d. In paragraph .06:

- The first sentence is deleted.
- In the last sentence, the word "competence" is replaced with the word "appropriateness."
- The following note is added to the paragraph:

> Note: Auditing Standard No. 15, *Audit Evidence*, discusses the appropriateness of

audit evidence, and Auditing Standard No. 14, *Evaluating Audit Results,* discusses the auditor's responsibilities for evaluating the sufficiency and appropriateness of audit evidence.

e. Paragraph .08 is deleted.

f. In paragraph .09:

- The sentence in paragraph .09 referring to section 313, which is in parentheses, is deleted.

- The following note is added to the paragraph:

  Note: Auditing Standard No. 8, *Audit Risk,* describes audit risk and its components in a financial statement audit – the risk of material misstatement (consisting of inherent risk and control risk) and detection risk.

g. In paragraph .11:

- The phrase "(see section 311, *Planning and Supervision*)" is deleted.

- The sentence "(See section 313.)" is deleted.

h. The second sentence of paragraph .15 is replaced with:

   See Auditing Standard No. 9, *Audit Planning*.

i. In the first bullet in paragraph .16, the phrase "(see section 326, *Evidential Matter*)" is deleted.

j. In the second bullet of paragraph .16, the phrase "Preliminary judgments about materiality levels" is replaced with the phrase "Tolerable misstatement. (See paragraphs .18-.18A.)"

k. Paragraph .18 is replaced with:

   Evaluation in monetary terms of the results of a sample for a substantive test of details contributes directly to the auditor's purpose, since such an evaluation can be related to his or her judgment of the monetary amount of misstatements that would be material. When planning a sample for a substantive test of details, the auditor should consider how much monetary misstatement in the related account balance or class of transactions may exist, in combination with other misstatements, without causing the financial statements to be materially misstated. This maximum monetary misstatement for the account balance or class of transactions is called *tolerable misstatement*.

l. Paragraph .18A is added:

Paragraphs 8 - 9 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, describe the auditor's responsibilities for determining tolerable misstatement at the account or disclosure level. When the population to be sampled constitutes a portion of an account balance or transaction class, the auditor should determine tolerable misstatement for the population to be sampled for purposes of designing the sampling plan. Tolerable misstatement for the population to be sampled ordinarily should be less than tolerable misstatement for the account balance or transaction class to allow for the possibility that misstatement in the portion of the account or transaction class not subject to audit sampling, individually or in combination with other misstatements, would cause the financial statements to be materially misstated.

m. Paragraph .20 is deleted.

n. The first sentence of paragraph .21 is replaced with the following sentence:

The sufficiency of tests of details for a particular account balance or class of transactions is related to the individual importance of the items examined as well as to the potential for material misstatement.

o. Paragraph .23 is replaced with:

To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account tolerable misstatement for the population; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements.

p. Paragraph .23A is added:

Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

q. The last sentence of paragraph .25 is replaced with:

The auditor also should evaluate whether the reasons for his or her inability to examine the items have (a) implications in relation to his or her risk assessments (including the assessment of fraud risk), (b) implications regarding the integrity of management or employees, and (c) possible effects on other aspects of the audit.

r. Footnote 6 to paragraph .26 is replaced with:

Paragraphs 10 through 23 of Auditing Standard No. 14, *Evaluating Audit Results,* discuss the auditor's consideration of differences between the accounting records and the underlying facts and circumstances.

s. Within footnote 7 to paragraph .32, the phrase "(see section 319.85)" is deleted. In the first sentence of the footnote, the phrase "often plans" is replaced with the phrase "may plan." The last sentence of the footnote, which is in brackets, is deleted.

t. The last sentence of paragraph .38 is replaced with:

When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

u. The fifth sentence of paragraph .39 is replaced with:

Paragraphs 44 through 46 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, describe the auditor's responsibilities for performing procedures between the interim date of testing and period end.

v. In paragraph .39, the last sentence, which is in brackets, is deleted.

w. In paragraph .44:

- The first sentence is replaced with:

  In some circumstances, the auditor may design a sample that will be used for dual purposes: as a test of control and as a substantive test.

- The third sentence is replaced with:

  For example, an auditor designing a test of a control over entries in the voucher register may design a related substantive test at a risk level that is based on an expectation of reliance on the control.

- The fifth sentence is replaced with:

  In evaluating such tests, deviations from the control that was tested and monetary misstatements should be evaluated separately using the risk levels applicable for the respective purposes.

- The following Note is added to the paragraph:

  > Note: Paragraph 47 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, provides additional discussion of the auditor's responsibilities for performing dual-purpose tests.

x. The reference in paragraph .45 to paragraph .04 is changed to a reference to paragraph .03.

y. In item 2 of paragraph .48, the last sentence is deleted.

z. Within footnote 1 to item 4 in paragraph .48, the sentence "(See section 313.)" is deleted.

aa. The sentence in item 6 of paragraph .48 "(See section 313.)" is deleted.

AU sec. 9350, "Audit Sampling: Auditing Interpretations of Section 350"

AU sec. 9350, "Audit Sampling: Auditing Interpretations of Section 350," is superseded.

AU sec. 380, "Communication With Audit Committees"

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees"), as amended, is amended as follows:

In footnote 5 to paragraph .10, the reference to section 316A.38 -.40 is replaced with a reference to AU secs. 316.79 -.82; the reference to section 316A is replaced with a reference to section 316.

AU sec. 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles"

SAS No. 69, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles" (AU sec. 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles"), as amended, is amended as follows:

a. In paragraph .04, the reference in (c) to section 431 is replaced with a reference to paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*; in (d), the reference to section 431 is replaced with a reference to paragraph 31 of Auditing Standard No. 14.

b. The reference in footnote 1 to paragraph .04 to 312.10 is replaced with a reference to Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*.

AU sec. 431, "Adequacy of Disclosure in Financial Statements"

SAS No. 32, "Adequacy of Disclosure in Financial Statements" (AU sec. 431, "Adequacy of Disclosure in Financial Statements"), as amended, is superseded.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements" (AU sec. 508, "Reports on Audited Financial Statements"), as amended, is amended as follows:

a. In paragraph 18C, the phrase "and in AU sec. 431" is deleted.

b. In subparagraph .20.a., the word "competent" is replaced with the word "appropriate."

c. In the second sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."

d. In the third sentence of paragraph .24, the word "competent" is replaced with the word "appropriate."

e. In footnote 15 to paragraph .38, the first sentence is replaced with:

   In this context, practicable means that the information is reasonably obtainable from management's accounts and records and that providing the information in the report does not require the auditor to assume the position of a preparer of financial information.

f. The references in paragraph .49 to section 312, *Audit Risk and Materiality,* and to section 342, *Auditing Accounting Estimates*, are replaced with a reference to paragraph 13 of Auditing Standard No. 14, *Evaluating Audit Results*.

g. In the first sentence of paragraph .63, the word "competent" is replaced with the word "appropriate."

h. In paragraph .66, the second sentence is replaced with:

   (See paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.)*

AU sec. 9508, "Reports on Audited Financial Statements: Auditing Interpretations of Section 508"

AU sec. 9508, "Reports on Audited Financial Statements: Auditing Interpretations of Section 508," is amended as follows:

In paragraph .02, the word "competent" is replaced with the word "appropriate."

AU sec. 530, "Dating of the Independent Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 530, "Dating of the Independent Auditor's Report" (AU sec. 530, "Dating of the Independent Auditor's Report"), as amended, is amended as follows:

a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."

b. In the second note to paragraph .01, the word "competent" is replaced with the word "appropriate."

c. In the first sentence of paragraph .05, the word "competent" is replaced with the word "appropriate."

AU sec. 543, "Part of Audit Performed by Other Independent Auditors"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 543 "Part of Audit Performed by Other Independent Auditors" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), as amended, is amended as follows:

a. The following note is added as the second note to paragraph .01:

   Note: For situations in which the auditor engages an accounting firm or individual accountants to participate in the audit engagement and AU sec. 543 does not apply, the auditor should supervise them in accordance with the requirements of Auditing Standard No. 10, *Supervision of the Audit Engagement*.

b. Within paragraph .12:

   - Subparagraph b. is replaced with:

A list of significant risks, the auditor's responses, and the results of the auditor's related procedures.

- Subparagraph f. is replaced with:

  A schedule of accumulated misstatements, including a description of the nature and cause of each accumulated misstatement, and an evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543"

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543," as amended, is amended as follows:

a. Paragraph .16 is replaced with:

   Interpretation − The principal auditor's response should ordinarily be made by the engagement partner. The engagement partner should take those steps that he or she considers reasonable under the circumstances to be informed of known matters pertinent to the other auditor's inquiry. For example, the engagement partner may inquire of engagement team members responsible for various aspects of the engagement or he or she may direct engagement team members to bring to his or her attention any significant matters of which they become aware during the audit. The principal auditor is not required to perform any procedures directed toward identifying matters that would not affect his or her audit or his or her report.

b. Footnote 4 to paragraph .16 is deleted.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

a. Within footnote 7 to paragraph .11, the first sentence is replaced with:

Paragraphs 10 through 23 of Auditing Standard No. 14, *Evaluating Audit Results*, require the auditor to accumulate and evaluate the misstatements identified during the audit.

b. The reference in paragraph .13 to section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

c. Within the last sentence of paragraph .16, the title of section 329, "Analytical Procedures," is replaced with the title "Substantive Analytical Procedures."

d. Footnote 20 to paragraph .26 is deleted.

e. The reference in paragraph .56, subparagraph C5, to section 319 is replaced with a reference to section 316.

<u>Auditing Standard No. 3, *Audit Documentation*</u>

Auditing Standard No. 3, *Audit Documentation*, as amended, is amended as follows:

a. Within paragraph 3, subparagraph b. is replaced with:

Supervisory personnel who review documentation prepared by other members of the engagement team.

b. Paragraph 9A is added:

Documentation of risk assessment procedures and responses to risks of misstatement should include (1) a summary of the identified risks of misstatement and the auditor's assessment of risks of material misstatement at the financial statement and assertion levels and (2) the auditor's responses to the risks of material misstatement, including linkage of the responses to those risks.

c. Within paragraph 12:

- Within subparagraph a.:, (1) a footnote reference 2A is added at the end of the first sentence:

  See paragraphs 12-13 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* and paragraphs .66-.67 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

and (2) the second sentence of subparagraph a. is deleted.

- Subparagraph b. is replaced with:

  Results of auditing procedures that indicate a need for significant modification of planned auditing procedures, the existence of material misstatements (including omissions in the financial statements), and the existence of significant deficiencies or material weaknesses in internal control over financial reporting.

- Subparagraph c. is replaced with:

  Accumulated misstatements and evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

- Footnote 2B is added to subparagraph c.:

  See paragraphs 10-23 of Auditing Standard No. 14, *Evaluating Audit Results.*

- Subparagraph d. is replaced with:

  Disagreements among members of the engagement team or with others consulted on the engagement about final conclusions reached on significant accounting or auditing matters, including the basis for the final resolution of those disagreements. If an engagement team member disagrees with the final conclusions reached, he or she should document that disagreement.

- Subparagraph f. is replaced with:

  Significant changes in the auditor's risk assessments, including risks that were not identified previously, and the modifications to audit procedures or additional audit procedures performed in response to those changes.

- Footnote 2C is added to subparagraph f.:

See paragraph 74 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, and paragraph 36 of Auditing Standard No. 14, *Evaluating Audit Results.*

- Subparagraph f-1. is added:

  Risks of material misstatement that are determined to be significant risks and the results of the auditing procedures performed in response to those risks.

d. Within paragraph 19:

- Subparagraph b. is replaced with:

  A list of significant risks, the auditor's responses, and the results of the auditor's related procedures.

- Subparagraph f. is replaced with:

  A schedule of accumulated misstatements, including a description of the nature and cause of each accumulated misstatement, and an evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

e. Paragraph 21 and the preceding heading, "Effective Date," are deleted.

<u>Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*</u>

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, as amended, is amended as follows:

In the first sentence of paragraph 18, the word "competent" is replaced with the word "appropriate."

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, is amended as follows:

a. In the second sentence of paragraph 3, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph 9, the phrase "any assistants" is replaced with the phrase "the engagement team members."

c. Within footnote 10 to paragraph 14, the reference to paragraphs .19-.42 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

d. The reference in paragraph 15 to AU sec. 316.44 and .45 is replaced with a reference to paragraphs 65-69 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

e. Within footnote 11 to paragraph 20, the reference to AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*.

f. Within footnote 12 to paragraph 28, the reference to AU sec. 326, *Evidential Matter*, is replaced with a reference to Auditing Standard No. 15, *Audit Evidence*.

g. Within footnote 13 to the note to paragraph 31, the reference to AU sec. 312.39 is replaced with a reference to paragraph 14 of Auditing Standard No. 14, *Evaluating Auditing Results*. The reference to AU sec. 316.50 is replaced with a reference to paragraph 5 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

h. The references in paragraph 36 to paragraphs .16-.20, .30-.32, and .77-.79 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, are replaced with references to paragraph 29 and Appendix B of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

i. In the first sentence of paragraph 51, the word "competent" is replaced with the word "appropriate."

j. In the first sentence of paragraph 89, the word "competent" is replaced with the word "appropriate."

k. Within the note to paragraph C6 in Appendix C, the word "competent" is replaced with the word "appropriate."

Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*

Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, is amended as follows:

a. Footnote 3 to paragraph 4 is deleted.

b. In paragraph 10, the reference to AU sec. 431, *Adequacy of Disclosure in Financial Statements*, is replaced with a reference to paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.*

Auditing Standard No. 7, *Engagement Quality Review*

Auditing Standard No. 7, *Engagement Quality Review*, is amended as follows:

a. Footnote 3 to paragraph 5 is replaced with:

> The term "engagement partner" has the same meaning as the "practitioner-in-charge of an engagement" in PCAOB interim quality control standard QC sec. 40, *The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement*. QC sec. 40 describes the competencies required of a practitioner-in-charge of an attest engagement.

b. In paragraph 10, the note following subparagraph b. is replaced with:

> Note: A *significant risk* is a risk of material misstatement that requires special audit consideration.

Ethics Standards

ET sec. 102, "Integrity and Objectivity"

ET sec. 102, "Integrity and Objectivity," is amended as follows:

Footnote 1 to paragraph .05 is replaced with:

See paragraph 5.b. of Auditing Standard No. 10, *Supervision of the Audit Engagement,* and paragraph 12.d. of Auditing Standard No. 3, *Audit Documentation*.

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. PCAOB-2010-01)

September 14, 2010

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on September 14, 2010, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission") the proposed rules described in Items I and II below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rules

On August 5, 2010, the Board adopted the following eight auditing standards:

- Auditing Standard No. 8, Audit Risk
- Auditing Standard No. 9, Audit Planning
- Auditing Standard No. 10, Supervision of the Audit Engagement
- Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit
- Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement

- Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement

- Auditing Standard No. 14, Evaluating Audit Results

- Auditing Standard No. 15, Audit Evidence

(collectively referred to as the "Risk Assessment Standards"); and amendment to the Board's interim auditing standards (collectively, "the proposed rules "). The text of the Risk Assessment Standards and amendments to the Board's interim auditing standards are set out below.

Auditing Standard No. 8

Audit Risk

Introduction

1. This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit[1/] or an audit of financial statements only.

1/ When the auditor is performing an integrated audit of financial statements and internal control over financial reporting, the requirements in Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, also apply. However, the risks of material misstatement of the financial statements are the same for both the audit of financial statements and the audit of internal control over financial reporting.

Objective

2. The objective of the auditor is to conduct the audit of financial statements in a manner that reduces audit risk to an appropriately low level.

Audit Risk

3. To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement[2/] due to error or fraud. Reasonable assurance[3/] is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.

4. In an audit of financial statements, audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial reporting framework. Audit risk is a function of the risk of material misstatement and detection risk.

[2/] Misstatement is defined in Appendix A of Auditing Standard No. 14, Evaluating Audit Results.

[3/] See AU sec. 110, Responsibilities and Functions of the Independent Auditor, and paragraph .10 of AU sec. 230, Due Professional Care in the Performance of Work, for a further discussion of reasonable assurance.

Note: The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

Risk of Material Misstatement

5. The risk of material misstatement refers to the risk that the financial statements are materially misstated. Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, indicates that the auditor should assess the risks of material misstatement at two levels: (1) at the financial statement level and (2) at the assertion[4/] level.[5/]

6. Risks of material misstatement at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of material misstatement at the financial statement level may be especially relevant to the auditor's consideration of the risk of material misstatement due to fraud. For example, an ineffective control environment, a lack of sufficient capital to continue operations, and declining conditions affecting the company's industry might create pressures or opportunities for management to manipulate the financial statements, leading to higher risk of material misstatement.

[4/] See Auditing Standard No. 15, Audit Evidence, for a description of financial statement assertions.

[5/] Paragraph 59 of Auditing Standard No. 12.

7. Risk of material misstatement at the assertion level consists of the following components:

a. Inherent risk, which refers to the susceptibility of an assertion to a misstatement, due to error or fraud, that could be material, individually or in combination with other misstatements, before consideration of any related controls.

b. Control risk, which is the risk that a misstatement due to error or fraud that could occur in an assertion and that could be material, individually or in combination with other misstatements, will not be prevented or detected on a timely basis by the company's internal control. Control risk is a function of the effectiveness of the design and operation of internal control.

8. Inherent risk and control risk are related to the company, its environment, and its internal control, and the auditor assesses those risks based on evidence he or she obtains. The auditor assesses inherent risk using information obtained from performing risk assessment procedures and considering the characteristics of the accounts and disclosures in the financial statements.[6/] The auditor assesses control risk using evidence obtained

[6/] Paragraph 59.a. of Auditing Standard No. 12.

from tests of controls (if the auditor plans to rely on those controls to assess control risk at less than maximum) and from other sources.[7/]

Detection Risk

9. In an audit of financial statements, detection risk is the risk that the procedures performed by the auditor will not detect a misstatement that exists and that could be material, individually or in combination with other misstatements. Detection risk is affected by (1) the effectiveness of the substantive procedures and (2) their application by the auditor, i.e., whether the procedures were performed with due professional care.

10. The auditor uses the assessed risk of material misstatement to determine the appropriate level of detection risk for a financial statement assertion. The higher the risk of material misstatement, the lower the level of detection risk needs to be in order to reduce audit risk to an appropriately low level.

11. The auditor reduces the level of detection risk through the nature, timing, and extent of the substantive procedures performed. As the appropriate level of detection risk decreases, the evidence from substantive procedures that the auditor should obtain increases.[8/]

[7/] Paragraphs 32-34 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

[8/] Paragraph 37 of Auditing Standard No. 13.

Auditing Standard No. 9

Audit Planning

Introduction

1. This standard establishes requirements regarding planning an audit.

Objective

2. The objective of the auditor is to plan the audit so that the audit is conducted effectively.

Responsibility of the Engagement Partner for Planning

3. The **engagement partner**[9/] is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for planning the audit and may seek assistance from appropriate engagement team members in fulfilling this responsibility. Engagement team members who assist the engagement partner with audit planning also should comply with the relevant requirements in this standard.

Planning an Audit

4. The auditor should properly plan the audit. This standard describes the auditor's

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[9/] Terms defined in Appendix A, Definitions, are set in **boldface type** the first time they appear.

responsibilities for properly planning the audit.[10/]

5. Planning the audit includes establishing the overall audit strategy for the engagement and developing an audit plan, which includes, in particular, planned risk assessment procedures and planned responses to the risks of material misstatement. Planning is not a discrete phase of an audit but, rather, a continual and iterative process that might begin shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit.

Preliminary Engagement Activities

6. The auditor should perform the following activities at the beginning of the audit:

a. Perform procedures regarding the continuance of the client relationship and the specific audit engagement,[11/]

b. Determine compliance with independence and ethics requirements, and

> Note: The determination of compliance with independence and ethics requirements is not limited to

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[10/] The term, "auditor," as used in this standard, encompasses both the engagement partner and the engagement team members who assist the engagement partner in planning the audit.

[11/] Paragraphs .14-.16 of QC sec. 20, System of Quality Control for a CPA Firm's Accounting and Auditing Practice. AU sec. 161, The Relationship of Generally Accepted Auditing Standards to Quality Control Standards, explains how the quality control standards relate to the conduct of audits.

preliminary engagement activities and should be reevaluated with changes in circumstances.

c. Establish an understanding with the client regarding the services to be performed on the engagement.[12/]

Planning Activities

7. The nature and extent of planning activities that are necessary depend on the size and complexity of the company, the auditor's previous experience with the company, and changes in circumstances that occur during the audit. When developing the audit strategy and audit plan, as discussed in paragraphs 8-10, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures:

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;

[12/] AU sec. 310, Appointment of the Independent Auditor.

- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality,[13/] risk, and, in integrated audits, other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee[14/] or management;
- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;
- Preliminary judgments about the effectiveness of internal control over financial reporting;

[13/] Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit.

[14/] If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;

- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and

- The relative complexity of the company's operations.

  Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

Audit Strategy

8. The auditor should establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan.

9. In establishing the overall audit strategy, the auditor should take into account:

a. The reporting objectives of the engagement and the nature of the communications required by PCAOB standards,[15/]

b. The factors that are significant in directing the activities of the engagement team,[16/]

c. The results of preliminary engagement activities[17/] and the auditor's evaluation of the important matters in accordance with paragraph 7 of this standard, and

d. The nature, timing, and extent of resources necessary to perform the engagement.[18/]

15/ See, e.g., AU sec. 310 and AU sec. 380, Communication With Audit Committees. Also, various laws or regulations require other matters to be communicated. (See, e.g., Rule 2-07 of Regulation S-X, 17 CFR 210.2-07; and Rule 10A-3 under the Securities Exchange Act of 1934, 17 CFR 240.10A-3.) The requirements of this standard do not modify communications required by those other laws or regulations.

16/ See, e.g., paragraph 6 of Auditing Standard No. 10, Supervision of the Audit Engagement.

17/ Paragraph 6 of this standard.

18/ See, e.g., paragraph .06 of AU sec. 230, Due Professional Care in the Performance of Work, paragraph 16 of this standard, and paragraph 5.a. of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

Audit Plan

10. The auditor should develop and document an audit plan that includes a description of:

a. The planned nature, timing, and extent of the risk assessment procedures;[19]

b. The planned nature, timing, and extent of tests of controls and substantive procedures;[20] and

c. Other planned audit procedures required to be performed so that the engagement complies with PCAOB standards.

Multi-location Engagements

11. In an audit of the financial statements of a company with operations in multiple locations or business units,[21] the auditor should determine the extent to which audit procedures should be performed at selected locations or business units to obtain sufficient

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19/ Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

20/ Auditing Standard No. 13 and Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

21/ The term "business units" includes subsidiaries, divisions, branches, components, or investments.

appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual locations or business units. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit.

12. Factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures include:

a. The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including, e.g., significant transactions executed at the location or business unit that are outside the normal course of business for the company, or that otherwise appear to be unusual given the auditor's understanding of the company and its environment;[22/]

[22/] Paragraph .66 of AU sec. 316, Consideration of Fraud in a Financial Statement Audit.

b. The materiality of the location or business unit;[23/]

c. The specific risks associated with the location or business unit that present a reasonable possibility[24/] of material misstatement to the company's consolidated financial statements;

d. Whether the risks of material misstatement associated with the location or business unit apply to other locations or business units such that, in combination, they present a reasonable possibility of material misstatement to the company's consolidated financial statements;

e. The degree of centralization of records or information processing;

f. The effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or business unit; and

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23/ Paragraph 10 of Auditing Standard No. 11 describes the consideration of materiality in planning and performing audit procedures at an individual location or business unit.

24/ There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

g. The frequency, timing, and scope of monitoring activities by the company or others at the location or business unit.

> Note: When performing an audit of internal control over financial reporting, refer to Appendix B, Special Topics, of Auditing Standard No. 5[25/] for considerations when a company has multiple locations or business units.

13. In determining the locations or business units at which to perform audit procedures, the auditor may take into account relevant activities performed by internal audit, as described in AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements, or others, as described in Auditing Standard No. 5. AU sec. 322 and Auditing Standard No. 5 establish requirements regarding using the work of internal audit and others, respectively.

14. AU sec. 543, Part of Audit Performed by Other Independent Auditors, describes the auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or more of the locations or business units that are included in the consolidated financial statements.[26/] In those situations, the

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[25/] Paragraphs B10-B16 of Auditing Standard No. 5.

[26/] For integrated audits, see also paragraphs C8-C11 of Auditing Standard No. 5.

auditor should perform the procedures in paragraphs 11-13 of this standard to determine the locations or business units at which audit procedures should be performed.

Changes During the Course of the Audit

15. The auditor should modify the overall audit strategy and the audit plan as necessary if circumstances change significantly during the course of the audit, including changes due to a revised assessment of the risks of material misstatement or the discovery of a previously unidentified risk of material misstatement.

Persons with Specialized Skill or Knowledge

16. The auditor should determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

17. If a person with specialized skill or knowledge employed or engaged by the auditor participates in the audit, the auditor should have sufficient knowledge of the subject matter to be addressed by such a person to enable the auditor to:

a. Communicate the objectives of that person's work;

b. Determine whether that person's procedures meet the auditor's objectives; and

c. Evaluate the results of that person's procedures as they relate to the nature, timing, and extent of other planned audit procedures and the effects on the auditor's report.

Additional Considerations in Initial Audits

18. The auditor should undertake the following activities before starting an initial audit:

a. Perform procedures regarding the acceptance of the client relationship and the specific audit engagement; and

b. Communicate with the predecessor auditor in situations in which there has been a change of auditors in accordance with AU sec. 315, Communications Between Predecessor and Successor Auditors.

19. The purpose and objective of planning the audit are the same for an initial audit or a recurring audit engagement. However, for an initial audit, the auditor should determine the additional planning activities necessary to establish an appropriate audit strategy and audit plan, including determining the audit procedures necessary to obtain sufficient appropriate audit evidence regarding the opening balances.[27/]

[27/] See also paragraph 3 of Auditing Standard No. 6, Evaluating Consistency of Financial Statements.

<u>APPENDIX A</u> – Definition

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Engagement partner – The member of the engagement team with primary responsibility for the audit.

Auditing Standard No. 10

<u>Supervision of the Audit Engagement</u>

<u>Introduction</u>

1. This standard establishes requirements regarding supervision of the audit engagement, including supervising the work of engagement team members.

<u>Objective</u>

2. The objective of the auditor is to supervise the audit engagement, including supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

Responsibility of the Engagement Partner for Supervision

3. The **engagement partner**[28/] is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for proper supervision of the work of engagement team members and for compliance with PCAOB standards, including standards regarding using the work of specialists,[29/] other auditors,[30/] internal auditors,[31/] and others who are involved in testing controls.[32/] Paragraphs 5-6 of this standard describe the nature and extent of supervisory activities necessary for proper supervision of engagement team members.[33/]

4. The engagement partner may seek assistance from appropriate engagement team members in fulfilling his or her responsibilities pursuant to this standard. Engagement team members who assist the engagement partner with supervision of the work of other

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[28/] Terms defined in Appendix A, Definitions, are set in **boldface type** the first time they appear.

[29/] AU sec. 336, Using the Work of a Specialist.

[30/] AU sec. 543, Part of Audit Performed by Other Independent Auditors.

[31/] AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.

[32/] Paragraphs 16-19 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

[33/] See also paragraph .06 of AU sec. 230, Due Professional Care in the Performance of Work.

engagement team members also should comply with the requirements in this standard with respect to the supervisory responsibilities assigned to them.

Supervision of Engagement Team Members

5. The engagement partner and, as applicable, other engagement team members performing supervisory activities, should:

a. Inform engagement team members of their responsibilities,[34/] including:

(1) The objectives of the procedures that they are to perform;

(2) The nature, timing, and extent of procedures they are to perform; and

(3) Matters that could affect the procedures to be performed or the evaluation of the results of those procedures, including relevant aspects of the company, its environment, and its internal control over financial reporting,[35/] and possible accounting and auditing issues;

[34/] AU sec. 230.06 and paragraph 5 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, establish requirements regarding the appropriate assignment of engagement team members.

[35/] Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, describes the auditor's responsibilities for obtaining an understanding of the company, its environment, and its internal control over financial reporting.

b. Direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities so they can evaluate those issues and determine that appropriate actions are taken in accordance with PCAOB standards;[36/]

> Note: In applying due professional care in accordance with AU sec. 230, each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or the auditor's report regardless of how those disagreements or concerns may have arisen.

c. Review the work of engagement team members to evaluate whether:

   (1) The work was performed and documented;

   (2) The objectives of the procedures were achieved; and

[36/] See, e.g., paragraph 15 of Auditing Standard No. 9, Audit Planning, paragraph 74 of Auditing Standard No. 12, and paragraphs 20-23 and 35-36 of Auditing Standard No. 14, Evaluating Audit Results.

(3) The results of the work support the conclusions reached.[37/]

6. To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, the engagement partner and other engagement team members performing supervisory activities should take into account:

a. The nature of the company, including its size and complexity;[38/]

b. The nature of the assigned work for each engagement team member, including:

(1) The procedures to be performed, and

(2) The controls or accounts and disclosures to be tested;

c. The risks of material misstatement; and

d. The knowledge, skill, and ability of each engagement team member.[39/]

Note: In accordance with the requirements of paragraph 5 of Auditing Standard No. 13, The Auditor's Responses to

[37/] Auditing Standard No. 14 describes the auditor's responsibilities for evaluating the results of the audit, and Auditing Standard No. 3, Audit Documentation, establishes requirements regarding audit documentation.

[38/] Paragraph 10 of Auditing Standard No. 12.

[39/] See also paragraph 5.a. of Auditing Standard No. 13 and AU sec. 230.06.

the Risks of Material Misstatement, the extent of supervision of engagement team members should be commensurate with the risks of material misstatement.[40/]

APPENDIX A − Definition

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Engagement partner – The member of the engagement team with primary responsibility for the audit.

Auditing Standard No. 11

Consideration of Materiality in Planning and Performing an Audit

Introduction

1. This standard establishes requirements regarding the auditor's consideration of materiality in planning and performing an audit.[41/]

Materiality in the Context of an Audit

[40/] Paragraph 5.b. of Auditing Standard No. 13 indicates that the extent of supervision of engagement team members is part of the auditor's overall responses to the risks of material misstatement.

[41/] Auditing Standard No. 14 establishes requirements regarding the auditor's consideration of materiality in evaluating audit results.

2. In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[42/] As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him …."[43/]

3. To obtain reasonable assurance about whether the financial statements are free of material misstatement, the auditor should plan and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements. This includes being alert while planning and performing audit procedures for misstatements that could be material due to quantitative or qualitative factors. Also, the evaluation of uncorrected misstatements in accordance with Auditing Standard No. 14, Evaluating Audit Results, requires consideration of both qualitative and quantitative factors.[44/] However, it ordinarily is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors.

[42/] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

[43/] TSC Industries, 426 U.S. at 450.

[44/] Appendix B of Auditing Standard No. 14.

4. For integrated audits, Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, states, "In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements."[45/]

Objective

5. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing audit procedures.

Considering Materiality in Planning and Performing an Audit

Establishing a Materiality Level for the Financial Statements as a Whole

6. To plan the nature, timing, and extent of audit procedures, the auditor should establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This includes consideration of the company's earnings and other relevant factors. To determine the nature, timing, and extent of audit procedures, the materiality level for the financial statements as a whole needs to be expressed as a specified amount.

45/ Paragraph 20 of Auditing Standard No. 5.

> Note: If financial statements for the audit period are not available, the auditor may establish an initial materiality level based on estimated or preliminary financial statement amounts. In those situations, the auditor should take into account the effects of known or expected changes in the company's financial statements, including significant transactions or adjustments that are expected to be reflected in the financial statements at the end of the period.

Establishing Materiality Levels for Particular Accounts or Disclosures

7. The auditor should evaluate whether, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. If so, the auditor should establish separate materiality levels for those accounts or disclosures to plan the nature, timing, and extent of audit procedures for those accounts or disclosures.

> Note: Lesser amounts of misstatements could influence the judgment of a reasonable investor because of qualitative factors, e.g., because of the sensitivity of circumstances surrounding misstatements, such as conflicts of interest in related party transactions.

Determining Tolerable Misstatement

8. The auditor should determine the amount or amounts of tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level. The auditor should determine tolerable misstatement at an amount or amounts that reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the financial statements. Accordingly, tolerable misstatement should be less than the materiality level for the financial statements as a whole and, if applicable, the materiality level or levels for particular accounts or disclosures.

9. In determining tolerable misstatement and planning and performing audit procedures, the auditor should take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods.

Considerations for Multi-location Engagements

10. For purposes of the audit of the consolidated financial statements of a company with multiple locations or business units, the auditor should determine tolerable misstatement for the individual locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements.

Accordingly, tolerable misstatement at an individual location should be less than the materiality level for the financial statements as a whole.

Considerations as the Audit Progresses

11. The auditor should reevaluate the established materiality level or levels and tolerable misstatement when, because of changes in the particular circumstances or additional information that comes to the auditor's attention, there is a substantial likelihood that misstatements of amounts that differ significantly from the materiality level or levels that were established initially would influence the judgment of a reasonable investor. Situations in which changes in circumstances or additional information that comes to the auditor's attention would require such reevaluation include:

a. The materiality level or levels and tolerable misstatement were established initially based on estimated or preliminary financial statement amounts that differ significantly from actual amounts.

b. Events or changes in conditions occurring after the materiality level or levels and tolerable misstatement were established initially are likely to affect investors' perceptions about the company's financial position, results of operations, or cash flows.

> Note: Examples of such events or changes in conditions include (1) changes in laws, regulations, or the applicable

financial reporting framework that affect investors' expectations about the measurement or disclosure of certain items and (2) significant new contractual arrangements that draw attention to a particular aspect of a company's business that is separately disclosed in the financial statements.

12. If the auditor's reevaluation results in a lower amount for the materiality level or levels or tolerable misstatement than initially established by the auditor, the auditor should (1) evaluate the effect, if any, of the lower amount or amounts on his or her risk assessments and audit procedures and (2) modify the nature, timing, and extent of audit procedures as necessary to obtain sufficient appropriate audit evidence.

Note: The reevaluation of the materiality level or levels and tolerable misstatement is also relevant to the auditor's evaluation of uncorrected misstatements in accordance with Auditing Standard No. 14.[46/]

[46/] Paragraph 17 of Auditing Standard No. 14.

Auditing Standard No. 12

Identifying and Assessing Risks of Material Misstatement

Introduction

1. This standard establishes requirements regarding the process of identifying and assessing risks of material misstatement[47/] of the financial statements.

2. Paragraphs 4-58 of this standard discuss the auditor's responsibilities for performing **risk assessment procedures**.[48/] Paragraphs 59-73 of this standard discuss identifying and assessing the risks of material misstatement using information obtained from performing risk assessment procedures.

Objective

3. The objective of the auditor is to identify and appropriately assess the risks of material misstatement, thereby providing a basis for designing and implementing responses to the risks of material misstatement.

Performing Risk Assessment Procedures

4. The auditor should perform risk assessment procedures that are sufficient to provide

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47/ Paragraphs 5-8 of Auditing Standard No. 8, Audit Risk.

48/ Terms defined in Appendix A, Definitions, are set in **boldface type** the first time they appear.

a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud,[49/] and designing further audit procedures.[50/]

5. Risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. For example, external or company-specific factors can affect the judgments involved in determining accounting estimates or create pressures to manipulate the financial statements to achieve certain financial targets. Also, risks of material misstatement may relate to, e.g., personnel who lack the necessary financial reporting competencies, information systems that fail to accurately capture business transactions, or financial reporting processes that are not adequately aligned with the requirements in the applicable financial reporting framework. Thus, the audit procedures that are necessary to identify and appropriately assess the risks of material misstatement include consideration of both external factors and company-specific factors. This standard discusses the following risk assessment procedures:

[49/] AU sec. 316, Consideration of Fraud in a Financial Statement Audit, discusses fraud, its characteristics, and the types of misstatements due to fraud that are relevant to the audit, i.e., misstatements arising from fraudulent financial reporting and misstatements arising from asset misappropriation.

[50/] Auditing Standard No. 15, Audit Evidence, describes further audit procedures as consisting of tests of controls and substantive procedures.

a. Obtaining an understanding of the company and its environment (paragraphs 7-17);

b. Obtaining an understanding of internal control over financial reporting (paragraphs 18-40);

c. Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company (paragraphs 41-45);

d. Performing analytical procedures (paragraphs 46-48);

e. Conducting a discussion among engagement team members regarding the risks of material misstatement (paragraphs 49-53); and

f. Inquiring of the audit committee, management, and others within the company about the risks of material misstatement (paragraphs 54-58).

> Note: This standard describes an approach to identifying and assessing risks of material misstatement that begins at the financial statement level and with the auditor's overall understanding of the company and its environment and

works down to the significant accounts and disclosures and their relevant assertions.[51/]

6. In an integrated audit, the risks of material misstatement of the financial statements are the same for both the audit of internal control over financial reporting and the audit of financial statements. The auditor's risk assessment procedures should apply to both the audit of internal control over financial reporting and the audit of financial statements.

Obtaining an Understanding of the Company and Its Environment

7. The auditor should obtain an understanding of the company and its environment ("understanding of the company") to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. Obtaining an understanding of the company includes understanding:

a. Relevant industry, regulatory, and other external factors;

b. The nature of the company;

c. The company's selection and application of accounting principles, including related disclosures;

51/ Paragraph 11 of Auditing Standard No. 15 discusses financial statement assertions.

d. The **company's objectives and strategies** and those related **business risks** that might reasonably be expected to result in risks of material misstatement; and

e. The company's measurement and analysis of its financial performance.

8. In obtaining an understanding of the company, the auditor should evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.

Industry, Regulatory, and Other External Factors

9. Obtaining an understanding of relevant industry, regulatory, and other external factors encompasses industry factors, including the competitive environment and technological developments; the regulatory environment, including the applicable financial reporting framework[52/] and the legal and political environment;[53/] and external factors, including general economic conditions.

Nature of the Company

10. Obtaining an understanding of the nature of the company includes understanding:

52/ The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

53/ AU sec. 317, Illegal Acts by Clients, discusses the auditor's consideration of laws and regulations relevant to the audit.

- The company's organizational structure and management personnel;

- The sources of funding of the company's operations and investment activities, including the company's capital structure, noncapital funding (e.g., subordinated debt or dependencies on supplier financing), and other debt instruments;

- The company's significant investments, including equity method investments, joint ventures, and variable interest entities;

- The company's operating characteristics, including its size and complexity;

  Note: The size and complexity of a company might affect the risks of misstatement and how the company addresses those risks.

- The sources of the company's earnings, including the relative profitability of key products and services; and

- Key supplier and customer relationships.

  Note: The auditor should take into account the information gathered while obtaining an understanding of the nature of the company when determining the existence of related parties in accordance with AU sec. 334, Related Parties.

11. As part of obtaining an understanding of the company as required by paragraph 7, the auditor should consider performing the following procedures and the extent to which the procedures should be performed:

- Reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and, in an integrated audit, the effectiveness of the company's internal control over financial reporting, e.g., company-issued press releases, company-prepared presentation materials for analysts or investor groups, and analyst reports;

- Observing or reading transcripts of earnings calls and, to the extent publicly available, other meetings with investors or rating agencies;

- Obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses; and

- Obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders to identify potentially significant unusual developments (e.g., from Forms 3, 4, 5, 13D, and 13G).

Selection and Application of Accounting Principles, Including Related Disclosures

12. As part of obtaining an understanding of the company's selection and application of accounting principles, including related disclosures, the auditor should evaluate whether the company's selection and application of accounting principles are appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the relevant industry. Also, to identify and assess risks of material misstatement related to omitted, incomplete, or inaccurate disclosures, the auditor should develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.

13. The following matters, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles, including related disclosures:

- Significant changes in the company's accounting principles, financial reporting policies, or disclosures and the reasons for such changes;
- The financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles;

- The accounts or disclosures for which judgment is used in the application of significant accounting principles, especially in determining management's estimates and assumptions;
- The effect of significant accounting principles in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;
- The methods the company uses to account for significant and unusual transactions; and
- Financial reporting standards and laws and regulations that are new to the company, including when and how the company will adopt such requirements.

Company Objectives, Strategies, and Related Business Risks

14. The purpose of obtaining an understanding of the company's objectives, strategies, and related business risks is to identify business risks that could reasonably be expected to result in material misstatement of the financial statements.

> Note: Some relevant business risks might be identified through other risk assessment procedures, such as obtaining an understanding of the nature of the company and understanding industry, regulatory, and other external factors.

15. The following are examples of situations in which business risks might result in material misstatement of the financial statements:

- Industry developments (a potential related business risk might be, e.g., that the company does not have the personnel or expertise to deal with the changes in the industry.)

- New products and services (a potential related business risk might be, e.g., that the new product or service will not be successful.)

- Use of information technology ("IT") (a potential related business risk might be, e.g., that systems and processes are incompatible.)

- New accounting requirements (a potential related business risk might be, e.g., incomplete or improper implementation of a new accounting requirement.)

- Expansion of the business (a potential related business risk might be, e.g., that the demand for the company's products or services has not been accurately estimated.)

- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, e.g., incomplete or improper implementation of the strategy.)

- Current and prospective financing requirements (a potential related business risk might be, e.g., the loss of financing due to the company's inability to meet financing requirements.)

- Regulatory requirements (a potential related business risk might be, e.g., that there is increased legal exposure.)

  Note: Business risks could affect risks of material misstatement at the financial statement level, which would affect many accounts and disclosures in the financial statements. For example, a company's loss of financing or declining conditions affecting the company's industry could affect its ability to settle its obligations when due. This, in turn, could affect the risks of material misstatement related to, e.g., the classification of long-term liabilities or valuation of long-term assets, or it could result in substantial doubt about the company's ability to continue as a going concern. Other business risks could affect the risks of material misstatement for particular accounts, disclosures, or assertions. For example, an unsuccessful new product or service or failed business expansion might affect the risks of material misstatement related to the valuation of inventory and other related assets.

Company Performance Measures

16. The purpose of obtaining an understanding of the company's performance measures is to identify performance measures, whether external or internal, that affect the risks of material misstatement.

17. The following are examples of performance measures that might affect the risks of material misstatement:

- Measures that form the basis for contractual commitments or incentive compensation arrangements;
- Measures used by external parties, such as analysts and rating agencies, to review the company's performance; and
- Measures the company uses to monitor its operations that highlight unexpected results or trends that prompt management to investigate their cause and take corrective action, including correction of misstatements.

  Note: The first two examples represent performance measures that can affect the risks of material misstatement by creating incentives or pressures for management of the company to manipulate certain accounts or disclosures to achieve certain performance targets (or conceal a failure to achieve those targets). The third example represents performance measures that management might use to monitor risks affecting the financial statements.

Note: Smaller companies might have less formal processes to measure and review financial performance. In such cases, the auditor might identify relevant performance measures by considering the information that the company uses to manage the business.

<u>Obtaining an Understanding of Internal Control Over Financial Reporting</u>

18. The auditor should obtain a sufficient understanding of each component[54/] of internal control over financial reporting ("understanding of internal control") to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.

19. The nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company;[55/]

[54/] Paragraphs 21-22 of this standard discuss components of internal control over financial reporting.

[55/] Paragraph 13 of Auditing Standard No. 5, <u>An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements</u>, states, "The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its control objectives. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks."

the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting.

> Note: The auditor also might obtain an understanding of certain controls that are not part of internal control over financial reporting, e.g., controls over the completeness and accuracy of operating or other nonfinancial information used as audit evidence.[56/]

20. Obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.

> Note: Procedures the auditor performs to obtain evidence about design effectiveness include inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs, as described in paragraphs 37-38, that include these procedures ordinarily are sufficient to evaluate design effectiveness.

> Note: Determining whether a control has been implemented means determining whether the control exists and whether the company is using

[56/] Paragraph 10 of Auditing Standard No. 15.

it. The procedures to determine whether a control has been implemented may be performed in connection with the evaluation of its design. Procedures performed to determine whether a control has been implemented include inquiry of appropriate personnel, in combination with observation of the application of controls or inspection of documentation. Walkthroughs, as described in paragraphs 37-38, that include these procedures ordinarily are sufficient to determine whether a control has been implemented.

21. Internal control over financial reporting can be described as consisting of the following components:[57/]

- The control environment,
- The company's risk assessment process,
- Information and communication,
- Control activities, and
- Monitoring of controls.

[57/] Different internal control frameworks use different terms and approaches to describe the components of internal control over financial reporting.

22. Management might use an internal control framework with components that differ from the components identified in the preceding paragraph when establishing and maintaining the company's internal control over financial reporting. In evaluating the design of controls and determining whether they have been implemented in an audit of financial statements only, the auditor may use the framework used by management or another suitable, recognized framework.[58/] For integrated audits, Auditing Standard No. 5, states, "The auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting."[59/] If the auditor uses a suitable, recognized internal control framework with components that differ from those listed in the preceding paragraph, the auditor should adapt the requirements in paragraphs 23-36 of this standard to conform to the components in the framework used.

Control Environment

23. The auditor should obtain an understanding of the company's control environment, including the policies and actions of management, the board, and the audit committee concerning the company's control environment.

[58/] See Securities Exchange Act Release No. 34-47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

[59/] Paragraph 5 of Auditing Standard No. 5.

24. Obtaining an understanding of the control environment includes assessing:

- Whether management's philosophy and operating style promote effective internal control over financial reporting;

- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and

- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

  Note: In an audit of financial statements only, this assessment may be based on the evidence obtained in understanding the control environment, in accordance with paragraph 23, and the other relevant knowledge possessed by the auditor. In an integrated audit of financial statements and internal control over financial reporting, Auditing Standard No. 5[60/] describes the auditor's responsibility for evaluating the control environment.

25. If the auditor identifies a control deficiency[61/] in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor, as discussed in paragraphs 65-66 of this standard.

60/ Paragraph 25 of Auditing Standard No. 5.

61/ Paragraph A3 of Auditing Standard No. 5.

The Company's Risk Assessment Process

26. The auditor should obtain an understanding of management's process for:

a. Identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud ("fraud risks");

b. Assessing the likelihood and significance of misstatements resulting from those risks; and

c. Deciding about actions to address those risks.

27. Obtaining an understanding of the company's risk assessment process includes obtaining an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.

Information and Communication

28. Information System Relevant to Financial Reporting. The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including:

a. The classes of transactions in the company's operations that are significant to the financial statements;

b. The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported;

c. The related accounting records, supporting information, and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions;

d. How the information system captures events and conditions, other than transactions,[62/] that are significant to the financial statements; and

e. The period-end financial reporting process.

> Note: Appendix B discusses additional considerations regarding manual and automated systems and controls.

29. The auditor also should obtain an understanding of how IT affects the company's flow of transactions. (See Appendix B.)

> Note: The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the approach used to identify significant accounts and disclosures and their relevant assertions and,

[62/] Examples of such events and conditions include depreciation and amortization and conditions affecting the recoverability of assets.

when applicable, to select the controls to test, as well as to assess risk and allocate audit effort.

30. A company's business processes are the activities designed to:

a. Develop, purchase, produce, sell and distribute a company's products or services;

b. Record information, including accounting and financial reporting information; and

c. Ensure compliance with laws and regulations relevant to the financial statements.

31. Obtaining an understanding of the company's business processes assists the auditor in obtaining an understanding of how transactions are initiated, authorized, processed, and recorded.

32. A company's period-end financial reporting process, as referred to in paragraph 28.e., includes the following:

- Procedures used to enter transaction totals into the general ledger;

- Procedures related to the selection and application of accounting principles;[63/]

- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;

- Procedures used to record recurring and nonrecurring adjustments to the annual financial statements (and quarterly financial statements, if applicable); and

- Procedures for preparing annual financial statements and related disclosures (and quarterly financial statements, if applicable).

33. Communication. The auditor should obtain an understanding of how the company communicates financial reporting roles and responsibilities and significant matters relating to financial reporting to relevant company personnel and others, including:

- Communications between management, the audit committee, and the board of directors; and

- Communications to external parties, including regulatory authorities and shareholders.

[63/] Paragraphs 12-13 of this standard.

Control Activities

34. The auditor should obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures, as described in paragraph 18 of this standard.[64/] As the auditor obtains an understanding of the other components of internal control over financial reporting, he or she is also likely to obtain knowledge about some control activities. The auditor should use his or her knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control over financial reporting in determining the extent to which it is necessary to devote additional attention to obtaining an understanding of control activities to assess the factors that affect the risks of material misstatement and to design further audit procedures.

> Note: A broader understanding of control activities is needed for relevant assertions for which the auditor plans to rely on controls. Also, in the audit of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit.

[64/] Also see paragraph B5 of Appendix B of this standard.

Monitoring of Controls

35. The auditor should obtain an understanding of the major types of activities that the company uses to monitor the effectiveness of its internal control over financial reporting and how the company initiates corrective actions related to its controls.[65/]

36. An understanding of the company's monitoring activities includes understanding the source of the information used in the monitoring activities.

Performing Walkthroughs

37. As discussed in paragraph 20, the auditor may perform walkthroughs as part of obtaining an understanding of internal control over financial reporting. For example, the auditor may perform walkthroughs in connection with understanding the flow of transactions in the information system relevant to financial reporting, evaluating the design of controls relevant to the audit, and determining whether those controls have been implemented. In performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and IT that company personnel use. Walkthrough procedures usually include a combination of

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[65/] In some companies, internal auditors or others performing an equivalent function contribute to the monitoring of controls. AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements, establishes requirements regarding the auditor's consideration and use of the work of the internal audit function.

inquiry, observation, inspection of relevant documentation, and re-performance of controls.

Note: For integrated audits, Auditing Standard No. 5 establishes certain objectives that the auditor should achieve to further understand likely sources of potential misstatements and as part of selecting the controls to test. Auditing Standard No. 5 states that performing walkthroughs will frequently be the most effective way of achieving those objectives.[66/]

38. In performing a walkthrough, at the points at which important processing procedures occur, the auditor questions the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions, combined with the other walkthrough procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the auditor to gain an understanding of the different types of significant transactions handled by the process.

66/ See paragraphs 34-38 of Auditing Standard No. 5.

Relationship of Understanding of Internal Control to Tests of Controls

39. The objective of obtaining an understanding of internal control, as discussed in paragraph 18 of this standard, is different from testing controls for the purpose of assessing control risk[67/] or for the purpose of expressing an opinion on internal control over financial reporting in the audit of internal control over financial reporting.[68/] The auditor may obtain an understanding of internal control concurrently with performing tests of controls if he or she obtains sufficient appropriate evidence to achieve the objectives of both procedures. Also, the auditor should take into account the evidence obtained from understanding internal control when assessing control risk and, in the audit of internal control over financial reporting, forming an opinion about the effectiveness of internal control over financial reporting.

40. Relationship of Understanding of Internal Control to Evaluating Entity-Level Controls in an Audit of Internal Control Over Financial Reporting. Auditing Standard No. 5 states, "The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting."[69/] The procedures performed to obtain an understanding of certain components of internal control in accordance with this standard, e.g., the control

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[67/] Paragraphs 16-35 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

[68/] Paragraph B1 of Auditing Standard No. 5.

[69/] Paragraph 22 of Auditing Standard No. 5.

environment, the company's risk assessment process, information and communication, and monitoring of controls, might provide evidence that is relevant to the auditor's evaluation of entity-level controls.[70/] The auditor should take into account the evidence obtained from understanding internal control when determining the nature, timing, and extent of procedures necessary to support the auditor's conclusions about the effectiveness of entity-level controls in the audit of internal control over financial reporting.

Considering Information from the Client Acceptance and Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements

41. Client Acceptance and Retention and Audit Planning Activities. The auditor should evaluate whether information obtained from the client acceptance and retention evaluation process or audit planning activities is relevant to identifying risks of material misstatement. Risks of material misstatement identified during those activities should be assessed as discussed beginning in paragraph 59 of this standard.

42. Past Audits. In subsequent years, the auditor should incorporate knowledge obtained during past audits into the auditor's process for identifying risks of material misstatement, including when identifying significant ongoing matters that affect the risks of material

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[70/] The entity-level controls included in paragraph 24 of Auditing Standard No. 5 include controls related to the control environment; the company's risk assessment process; centralized processing and controls; controls over the period-end financial reporting process; and controls to monitor other controls.

misstatement or determining how changes in the company or its environment affect the risks of material misstatement, as discussed in paragraph 8 of this standard.

43. If the auditor plans to limit the nature, timing, or extent of his or her risk assessment procedures by relying on information from past audits, the auditor should evaluate whether the prior years' information remains relevant and reliable.

44. Other Engagements. When the auditor has performed a review of interim financial information in accordance with AU sec. 722, Interim Financial Information, the auditor should evaluate whether information obtained during the review is relevant to identifying risks of material misstatement in the year-end audit.

45. The auditor should obtain an understanding of the nature of the services that have been performed for the company by the auditor or affiliates of the firm[71/] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement.[72/]

Performing Analytical Procedures

46. The auditor should perform analytical procedures that are designed to:

71/ See PCAOB Rule 3501(a)(i), which defines "affiliate of the accounting firm."

72/ Paragraph 7 of Auditing Standard No. 9, Audit Planning.

a. Enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior year end; and

b. Identify areas that might represent specific risks relevant to the audit, including the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.

47. In applying analytical procedures as risk assessment procedures, the auditor should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud. Also, when the auditor has performed a review of interim financial information in accordance with AU sec. 722, he or she should take into account the analytical procedures applied in that review when designing and applying analytical procedures as risk assessment procedures.

48. When performing an analytical procedure, the auditor should use his or her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure.[73/] When comparison of those expectations with relationships derived from recorded amounts yields unusual or unexpected results,

[73/] Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

the auditor should take into account those results in identifying the risks of material misstatement.

> Note: Analytical procedures performed as risk assessment procedures often use data that is preliminary or data that is aggregated at a high level, and, in those instances, such analytical procedures are not designed with the level of precision necessary for substantive analytical procedures.

Conducting a Discussion among Engagement Team Members Regarding Risks of Material Misstatement

49. The key engagement team members should discuss (1) the company's selection and application of accounting principles, including related disclosure requirements, and (2) the susceptibility of the company's financial statements to material misstatement due to error or fraud.

> Note: The key engagement team members should discuss the potential for material misstatement due to fraud either as part of the discussion regarding risks of material misstatement or in a separate discussion.[74/]

> Note: As discussed in paragraph 67, the financial statements might be susceptible to misstatement through omission of required disclosures or presentation of inaccurate or incomplete disclosures.

[74/] Paragraphs 52-53 of this standard.

50. Key engagement team members include all engagement team members who have significant engagement responsibilities, including the engagement partner. The manner in which the discussion is conducted depends on the individuals involved and the circumstances of the engagement. For example, if the audit involves more than one location, there could be multiple discussions with team members in differing locations. The engagement partner or other key engagement team members should communicate the important matters from the discussion to engagement team members who are not involved in the discussion.

> Note: If the audit is performed entirely by the engagement partner, that engagement partner, having personally conducted the planning of the audit, is responsible for evaluating the susceptibility of the company's financial statements to material misstatement.

51. Communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change.[75/]

Discussion of the Potential for Material Misstatement Due to Fraud

52. The discussion among the key engagement team members about the potential for material misstatement due to fraud should occur with an attitude that includes a

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[75/] See also paragraph 29 of Auditing Standard No. 14, Evaluating Audit Results.

questioning mind, and the key engagement team members should set aside any prior beliefs they might have that management is honest and has integrity. The discussion among the key engagement team members should include:

- An exchange of ideas, or "brainstorming," among the key engagement team members, including the engagement partner, about how and where they believe the company's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the company could be misappropriated, including (a) the susceptibility of the financial statements to material misstatement through related party transactions and (b) how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures;
- A consideration of the known external and internal factors affecting the company that might (a) create incentives or pressures for management and others to commit fraud, (b) provide the opportunity for fraud to be perpetrated, and (c) indicate a culture or environment that enables management to rationalize committing fraud;
- A consideration of the risk of management override; and

- A consideration of the potential audit responses to the susceptibility of the company's financial statements to material misstatement due to fraud.

53. The auditor should emphasize the following matters to all engagement team members:

- The need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, as described in AU sec. 316;[76/]

- The need to be alert for information or other conditions (such as those matters presented in Appendix C of Auditing Standard No. 14) that might affect the assessment of fraud risks; and

- If information or other conditions indicate that a material misstatement due to fraud might have occurred, the need to probe the issues, acquire additional evidence as necessary, and consult with other team members and, if appropriate, others in the firm including specialists.[77/]

Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

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[76/] AU sec. 316.13.

[77/] Paragraphs 20-23 of Auditing Standard No. 14 establish further requirements for evaluating whether misstatements might be indicative of fraud and determining the necessary procedures to be performed in those situations.

54. The auditor should inquire of the audit committee, or equivalent (or its chair), management, the internal audit function, and others within the company who might reasonably be expected to have information that is important to the identification and assessment of risks of material misstatement.

> Note: The auditor's inquiries about risks of material misstatement should include inquiries regarding fraud risks.

55. The auditor should use his or her knowledge of the company and its environment, as well as information from other risk assessment procedures, to determine the nature of the inquiries about risks of material misstatement.

Inquiries Regarding Fraud Risks

56. The auditor's inquiries regarding fraud risks should include the following:

a. Inquiries of management regarding:

(1) Whether management has knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

(2) Management's process for identifying and responding to fraud risks in the company, including any specific fraud risks the company has identified or account balances or disclosures for

which a fraud risk is likely to exist, and the nature, extent, and frequency of management's fraud risk assessment process;

(3) Controls that the company has established to address fraud risks the company has identified, or that otherwise help to prevent and detect fraud, including how management monitors those controls;

(4) For a company with multiple locations (a) the nature and extent of monitoring of operating locations or business segments and (b) whether there are particular operating locations or business segments for which a fraud risk might be more likely to exist;

(5) Whether and how management communicates to employees its views on business practices and ethical behavior;

(6) Whether management has received tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, management's responses to such tips and complaints; and

(7) Whether management has reported to the audit committee on how the company's internal control serves to prevent and detect material misstatements due to fraud.

b. Inquiries of the audit committee, or equivalent, or its chair regarding:

(1) The audit committee's views about fraud risks in the company;

(2) Whether the audit committee has knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

(3) Whether the audit committee is aware of tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, the audit committee's responses to such tips and complaints; and

(4) How the audit committee exercises oversight of the company's assessment of fraud risks and the establishment of controls to address fraud risks.

c. If the company has an internal audit function, inquiries of appropriate internal audit personnel regarding:

(1) The internal auditors' views about fraud risks in the company;

(2) Whether the internal auditors have knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

(3) Whether internal auditors have performed procedures to identify or detect fraud during the year, and whether management has satisfactorily responded to the findings resulting from those procedures; and

(4) Whether internal auditors are aware of instances of management override of controls and the nature and circumstances of such overrides.

57. In addition to the inquiries outlined in the preceding paragraph, the auditor should inquire of others within the company about their views regarding fraud risks, including, in particular, whether they have knowledge of fraud, alleged fraud, or suspected fraud. The auditor should identify other individuals within the company to whom inquiries should be directed and determine the extent of such inquiries by considering whether others in the company might have additional knowledge about fraud, alleged fraud, or suspected fraud or might be able to corroborate fraud risks identified in discussions with management or the audit committee. Examples of other individuals within the company to whom inquiries might be directed include:

- Employees with varying levels of authority within the company, including, e.g., company personnel with whom the auditor comes into contact during the course of the audit (a) in obtaining an understanding of internal control, (b) in observing inventory or performing cutoff procedures, or (c) in obtaining explanations for significant differences identified when performing analytical procedures;

- Operating personnel not directly involved in the financial reporting process;
- Employees involved in initiating, recording, or processing complex or unusual transactions, e.g., a sales transaction with multiple elements or a significant related party transaction; and
- In-house legal counsel.

58. When evaluating management's responses to inquiries about fraud risks and determining when it is necessary to corroborate management's responses, the auditor should take into account the fact that management is often in the best position to commit fraud. Also, the auditor should obtain evidence to address inconsistencies in responses to the inquiries.

Identifying and Assessing the Risks of Material Misstatement

59. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. In identifying and assessing risks of material misstatement, the auditor should:

a. Identify risks of misstatement using information obtained from performing risk assessment procedures (as discussed in paragraphs 4-58) and considering the characteristics of the accounts and disclosures in the financial statements.

   Note: Factors relevant to identifying fraud risks are discussed in paragraphs 65-69 of this standard.

b. Evaluate whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions.

c. Evaluate the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected.

   Note: In identifying and assessing risks at the assertion level, the auditor should evaluate how risks at the financial statement level could affect risks of misstatement at the assertion level.

d. Assess the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements.

> Note: In assessing the likelihood and magnitude of potential misstatement, the auditor may take into account the planned degree of reliance on controls selected to test.[78/]

e. Identify significant accounts and disclosures[79/] and their relevant assertions[80/] (paragraphs 60-64 of this standard).

> Note: The determination of whether an account or disclosure is significant or whether an assertion is a

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78/ Paragraphs 16-35 of Auditing Standard No. 13.

79/ Paragraph A10 of Auditing Standard No. 5 states:

> An account or disclosure is a significant account or disclosure if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.

80/ Paragraph A9 of Auditing Standard No. 5 states:

> A relevant assertion is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

relevant assertion is based on inherent risk, without regard to the effect of controls.

f. Determine whether any of the identified and assessed risks of material misstatement are **significant risks** (paragraphs 70-71 of this standard).

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

60. To identify significant accounts and disclosures and their relevant assertions in accordance with paragraph 59.e., the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include:

- Size and composition of the account;
- Susceptibility to misstatement due to error or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;

- Exposure to losses in the account;
- Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- Existence of related party transactions in the account; and
- Changes from the prior period in account and disclosure characteristics.

61. As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.

62. The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the audit of internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits.

> Note: In the financial statement audit, the auditor might perform substantive auditing procedures on financial statement accounts,

disclosures, and assertions that are not determined to be significant accounts and disclosures and relevant assertions.[81/]

63. The components of a potential significant account or disclosure might be subject to significantly differing risks.

64. When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements.

Factors Relevant to Identifying Fraud Risks

65. The auditor should evaluate whether the information gathered from the risk assessment procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks. Fraud risk factors are events or conditions that indicate (1) an incentive or pressure to perpetrate fraud, (2) an opportunity to carry out the fraud, or (3) an attitude or rationalization that justifies the fraudulent action. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances in which fraud exists. Examples of

[81/] The auditor might perform substantive auditing procedures because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high or as a means of introducing unpredictability in the procedures performed. See paragraphs 11, 14, and 25 of Auditing Standard No. 14, for further discussion about undetected misstatement. See paragraph 61 of Auditing Standard No. 5 and paragraph 5.c. of Auditing Standard No. 13, for further discussion about the unpredictability of auditing procedures.

fraud risk factors related to fraudulent financial reporting and misappropriation of assets are listed in AU sec. 316.85. These illustrative risk factors are classified based on the three conditions discussed in this paragraph, which generally are present when fraud exists.

> Note: The factors listed in AU sec. 316.85 cover a broad range of situations and are only examples. Accordingly, the auditor might identify additional or different fraud risk factors.

66. All three conditions discussed in the preceding paragraph are not required to be observed or evident to conclude that a fraud risk exists. The auditor might conclude that a fraud risk exists even when only one of these three conditions is present.

67. <u>Consideration of the Risk of Omitted, Incomplete, or Inaccurate Disclosures</u>. The auditor's evaluation of fraud risk factors in accordance with paragraph 65 should include evaluation of how fraud could be perpetrated or concealed by presenting incomplete or inaccurate disclosures or by omitting disclosures that are necessary for the financial statements to be presented fairly in conformity with the applicable financial reporting framework.

68. <u>Presumption of Fraud Risk Involving Improper Revenue Recognition</u>. The auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.

69. Consideration of the Risk of Management Override of Controls. The auditor's identification of fraud risks should include the risk of management override of controls.

> Note: Controls over management override are important to effective internal control over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override.

Factors Relevant to Identifying Significant Risks

70. To determine whether an identified and assessed risk is a significant risk, the auditor should evaluate whether the risk requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk.

> Note: The determination of whether a risk of material misstatement is a significant risk is based on inherent risk, without regard to the effect of controls.

71. Factors that should be evaluated in determining which risks are significant risks include:

   a. The effect of the quantitative and qualitative risk factors discussed in paragraph 60 on the likelihood and potential magnitude of misstatements;

   b. Whether the risk is a fraud risk;

      Note: A fraud risk is a significant risk.

   c. Whether the risk is related to recent significant economic, accounting, or other developments;

   d. The complexity of transactions;

   e. Whether the risk involves significant transactions with related parties;

   f. The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

   g. Whether the risk involves significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature.

Further Consideration of Controls

72. When the auditor has determined that a significant risk, including a fraud risk, exists, the auditor should evaluate the design of the company's controls that are intended to address fraud risks and other significant risks and determine whether those controls have been implemented, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18-40 of this standard.[82/]

73. Controls that address fraud risks include (a) specific controls designed to mitigate specific risks of fraud, e.g., controls to address risks of intentional misstatement of specific accounts and (b) controls designed to prevent, deter, and detect fraud, e.g., controls to promote a culture of honesty and ethical behavior.[83/] Such controls also include those that address the risk of management override of other controls.

Revision of Risk Assessment

74. The auditor's assessment of the risks of material misstatement, including fraud risks, should continue throughout the audit. When the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify

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[82/] Auditing Standard No. 13 discusses the auditor's response to fraud risks and other significant risks.

[83/] AU sec. 316.88 and paragraph 14 of Auditing Standard No. 5 present examples of controls that address fraud risks.

planned audit procedures or perform additional procedures in response to the revised risk assessments.[84/]

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Business risks – Risks that result from significant conditions, events, circumstances, actions, or inactions that could adversely affect a company's ability to achieve its objectives and execute its strategies. Business risks also might result from setting inappropriate objectives and strategies or from changes or complexity in the company's operations or management.

A3. Company's objectives and strategies – The overall plans for the company as established by management or the board of directors. Strategies are the approaches by which management intends to achieve its objectives.

A4. Risk assessment procedures – The procedures performed by the auditor to obtain information for identifying and assessing the risks of material misstatement in the financial statements whether due to error or fraud.

> Note: Risk assessment procedures by themselves do not provide sufficient appropriate evidence on which to base an audit opinion.

[84/] See also paragraph 46 of Auditing Standard No. 13.

A5. Significant risk – A risk of material misstatement that requires special audit consideration.

APPENDIX B – Consideration of Manual and Automated Systems and Controls

B1. While obtaining an understanding of the company's information system related to financial reporting, the auditor should obtain an understanding of how the company uses information technology ("IT") and how IT affects the financial statements.[85/] The auditor also should obtain an understanding of the extent of manual controls and automated controls used by the company, including the IT general controls that are important to the effective operation of the automated controls. That information should be taken into account in assessing the risks of material misstatement.[86/]

B2. Controls in a manual system might include procedures such as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items.

B3. Alternatively, a company might use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format would replace paper documents. When IT is used to initiate, record, process, and report

85/ See also AU sec. 324, Service Organizations, if the company uses a service organization for services that are part of the company's internal control over financial reporting.

86/ See also paragraphs 16-17 of Auditing Standard No. 9, Audit Planning.

transactions, the IT systems and programs may include controls related to the relevant assertions of significant accounts and disclosures or may be critical to the effective functioning of manual controls that depend on IT.

B4. The auditor should obtain an understanding of specific risks to a company's internal control over financial reporting resulting from IT. Examples of such risks include:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both;
- Unauthorized access to data that might result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions or inaccurate recording of transactions (particular risks might arise when multiple users access a common database);
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down segregation of duties;
- Unauthorized changes to data in master files;
- Unauthorized changes to systems or programs;
- Failure to make necessary changes to systems or programs;

- Inappropriate manual intervention; and

- Potential loss of data or inability to access data as required.

B5. In obtaining an understanding of the company's control activities, the auditor should obtain an understanding of how the company has responded to risks arising from IT.

B6. When a company uses manual elements in internal control systems and the auditor plans to rely on, and therefore test, those manual controls, the auditor should design procedures to test the consistency in the application of those manual controls.

Auditing Standard No. 13

The Auditor's Responses to the Risks of Material Misstatement

Introduction

1. This standard establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement.

Objective

2. The objective of the auditor is to address the risks of material misstatement through appropriate overall audit responses and audit procedures.

Responding to the Risks of Material Misstatement

3. To meet the objective in the preceding paragraph, the auditor must design and implement audit responses that address the risks of material misstatement that are identified and assessed in accordance with Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

4. This standard discusses the following types of audit responses:

a. Responses that have an overall effect on how the audit is conducted ("overall responses"), as described in paragraphs 5-7; and

b. Responses involving the nature, timing, and extent of the audit procedures to be performed, as described in paragraphs 8-46.

Overall Responses

5. The auditor should design and implement overall responses to address the assessed risks of material misstatement as follows:

a. Making appropriate assignments of significant engagement responsibilities. The knowledge, skill, and ability of engagement team members with significant engagement responsibilities should be commensurate with the assessed risks of material misstatement.[87/]

b. Providing the extent of supervision that is appropriate for the circumstances, including, in particular, the assessed risks of material misstatement. (See paragraphs 5–6 of Auditing Standard No. 10, Supervision of the Audit Engagement.)

c. Incorporating elements of unpredictability in the selection of audit procedures to be performed. As part of the auditor's response to the assessed risks of material misstatement, including the assessed risks of material misstatement due to fraud ("fraud risks"), the auditor should incorporate an element of unpredictability in the selection of auditing procedures to be performed from year to year. Examples of ways to incorporate an element of unpredictability include:

   (1) Performing audit procedures related to accounts, disclosures, and assertions that would not otherwise be tested based on their amount or the auditor's assessment of risk;

[87/] See also paragraph .06 of AU sec. 230, Due Professional Care in the Performance of Work.

(2) Varying the timing of the audit procedures;

(3) Selecting items for testing that have lower amounts or are otherwise outside customary selection parameters;

(4) Performing audit procedures on an unannounced basis; and

(5) In multi-location audits, varying the location or the nature, timing, and extent of audit procedures at related locations or business units from year to year.[88/]

d. Evaluating the company's selection and application of significant accounting principles. The auditor should evaluate whether the company's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions,[89/] are indicative of bias that could lead to material misstatement of the financial statements.

[88/] For integrated audits, paragraphs 61 and B13 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, establish requirements for introducing unpredictability in testing of controls from year to year and in multi-location audits.

[89/] Paragraphs 12-13 of Auditing Standard No. 12 discuss the auditor's responsibilities regarding obtaining an understanding of the company's selection and application of accounting principles. See also paragraphs .66-.67 of AU sec. 316, Consideration of Fraud in a Financial Statement Audit, and paragraphs .04 and .06 of AU sec. 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.

Note: Paragraph .11 of AU sec. 380, Communication With Audit Committees, discusses the auditor's judgments about the quality of a company's accounting principles.

6. The auditor also should determine whether it is necessary to make pervasive changes to the nature, timing, or extent of audit procedures to adequately address the assessed risks of material misstatement. Examples of such pervasive changes include modifying the audit strategy to:

a. Increase the substantive testing of the valuation of numerous significant accounts at year end because of significantly deteriorating market conditions, and

b. Obtain more persuasive audit evidence from substantive procedures due to the identification of pervasive weaknesses in the company's control environment.

7. Due professional care requires the auditor to exercise professional skepticism.[90/] Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence. The auditor's responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit

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[90/] AU secs. 230.07-.09.

evidence.[91/] Examples of the application of professional skepticism in response to the assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or employed by the auditor, or examination of documentation from independent sources.

Responses Involving the Nature, Timing, and Extent of Audit Procedures

8. The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.

9. In designing the audit procedures to be performed, the auditor should:

   a. Obtain more persuasive audit evidence the higher the auditor's assessment of risk;

[91/] AU sec. 316.13.

b. Take into account the types of potential misstatements that could result from the identified risks and the likelihood and magnitude of potential misstatement;[92/]

c. In an integrated audit, design the testing of controls to accomplish the objectives of both audits simultaneously:

(1) To obtain sufficient evidence to support the auditor's control risk[93/] assessments for purposes of the audit of financial statements;[94/] and

(2) To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end.

Note: Auditing Standard No. 5 establishes requirements for tests of controls in the audit of internal control over financial reporting.

[92/] For example, potential misstatements regarding disclosures include omission of required disclosures or presentation of inaccurate or incomplete disclosures.

[93/] See paragraph 7.b. of Auditing Standard No. 8, Audit Risk, for a definition of control risk.

[94/] For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

10. The audit procedures performed in response to the assessed risks of material misstatement can be classified into two categories: (1) tests of controls and (2) substantive procedures.[95/] Paragraphs 16-35 of this standard discuss tests of controls, and paragraphs 36-46 discuss substantive procedures.

> Note: Paragraphs 16-17 of this standard discuss when tests of controls are necessary in a financial statement audit. Ordinarily, tests of controls are performed for relevant assertions for which the auditor chooses to rely on controls to modify his or her substantive procedures.

Responses to Significant Risks

11. For significant risks, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed risks.

> Note: Auditing Standard No. 12 discusses identification of significant risks[96/] and states that fraud risks are significant risks.

Responses to Fraud Risks

[95/] Substantive procedures consist of (a) tests of details of accounts and disclosures and (b) substantive analytical procedures.

[96/] See paragraph 71 of Auditing Standard No. 12 for factors that the auditor should evaluate in determining which risks are significant risks.

12. The audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected.

> Note: If the auditor identifies deficiencies in controls that are intended to address assessed fraud risks, the auditor should take into account those deficiencies when designing his or her response to those fraud risks.

> Note: Auditing Standard No. 5 establishes requirements for addressing assessed fraud risks in the audit of internal control over financial reporting.[97/]

13. Addressing Fraud Risks in the Audit of Financial Statements. In the audit of financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks. If the auditor selects certain controls intended to address the assessed fraud risks for testing in accordance with paragraphs 16-17 of this standard, the auditor should perform tests of those controls.

14. The following are examples of ways in which planned audit procedures may be modified to address assessed fraud risks:

a. Changing the nature of audit procedures to obtain evidence that is more reliable or to obtain additional corroborative information;

97/ Paragraphs 14-15 of Auditing Standard No. 5.

b. Changing the timing of audit procedures to be closer to the end of the period or to the points during the period in which fraudulent transactions are more likely to occur; and

c. Changing the extent of the procedures applied to obtain more evidence, e.g., by increasing sample sizes or applying computer-assisted audit techniques to all of the items in an account.

> Note: AU secs. 316.54-.67 provide additional examples of responses to assessed fraud risks relating to fraudulent financial reporting (e.g., revenue recognition, inventory quantities, and management estimates) and misappropriation of assets in the audit of financial statements.

15. Also, AU sec. 316 indicates that the auditor should perform audit procedures to specifically address the risk of management override of controls including:

a. Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud (AU secs. 316.58-.62);

b. Reviewing accounting estimates for biases that could result in material misstatement due to fraud (AU secs. 316.63-.65); and

c. Evaluating the business rationale for significant unusual transactions (AU secs. 316.66-.67).

Testing Controls

Testing Controls in an Audit of Financial Statements

16. Controls to be Tested. If the auditor plans to assess control risk at less than the maximum by relying on controls,[98/] and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire **period of reliance**.[99/] However, the auditor is not required to assess control risk at less than the maximum for all relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

17. Also, tests of controls must be performed in the audit of financial statements for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence and when necessary to support the auditor's reliance on the

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98/ Reliance on controls that is supported by sufficient and appropriate audit evidence allows the auditor to assess control risk at less than the maximum, which results in a lower assessed risk of material misstatement. In turn, this allows the auditor to modify the nature, timing, and extent of planned substantive procedures.

99/ Terms defined in Appendix A, Definitions, are set in **boldface type** the first time they appear.

accuracy and completeness of financial information used in performing other audit procedures.[100/]

> Note*:* When a significant amount of information supporting one or more relevant assertions is electronically initiated, recorded, processed, or reported, it might be impossible to design effective substantive tests that, by themselves, would provide sufficient appropriate evidence regarding the assertions. For such assertions, significant audit evidence may be available only in electronic form. In such cases, the sufficiency and appropriateness of the audit evidence usually depend on the effectiveness of controls over their accuracy and completeness. Furthermore, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively.

18. Evidence about the Effectiveness of Controls in the Audit of Financial Statements. In designing and performing tests of controls for the audit of financial statements, the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The auditor should

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[100/] Paragraph 10 of Auditing Standard No. 15, Audit Evidence, and paragraph .16 of AU sec. 329, Substantive Analytical Procedures.

obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. The auditor also should obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.

Testing Design Effectiveness

19. The auditor should test the design effectiveness of the controls selected for testing by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect error or fraud that could result in material misstatements in the financial statements.

> Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.

20. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.[101/]

Testing Operating Effectiveness

21. The auditor should test the operating effectiveness of a control selected for testing by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

22. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Obtaining Evidence from Tests of Controls

23. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing

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[101/] Paragraphs 37-38 of Auditing Standard No. 12 discuss performing a walkthrough.

might provide sufficient evidence in relation to the degree of reliance in an audit of financial statements.

> Note: To obtain evidence about whether a control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures.

Nature of Tests of Controls

24. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in the order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control.

> Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.

25. The nature of the tests of controls that will provide appropriate evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

Note: A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain controls, might provide sufficient evidence about whether the control is effective.

Extent of Tests of Controls

26. The more extensively a control is tested, the greater the evidence obtained from that test.

27. Matters that could affect the necessary extent of testing of a control in relation to the degree of reliance on a control include the following:

- The frequency of the performance of the control by the company during the audit period;
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control;
- The expected rate of deviation from a control;
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control;

- The extent to which audit evidence is obtained from tests of other controls related to the assertion;

- The nature of the control, including, in particular, whether it is a manual control or an automated control; and

- For an automated control, the effectiveness of relevant information technology general controls.

> Note: AU sec. 350, Audit Sampling, establishes requirements regarding the use of sampling in tests of controls.

Timing of Tests of Controls

28. The timing of tests of controls relates to when the evidence about the operating effectiveness of the controls is obtained and the period of time to which it applies. Paragraph 16 of this standard indicates that the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance.

29. Using Audit Evidence Obtained during an Interim Period. When the auditor obtains evidence about the operating effectiveness of controls as of or through an interim date, he

or she should determine what additional evidence is necessary concerning the operation of the controls for the remaining period of reliance.

30. The additional evidence that is necessary to update the results of testing from an interim date through the remaining period of reliance depends on the following factors:

- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date;

  Note: If there have been significant changes to the control since the interim date, the auditor should obtain evidence about the effectiveness of the new or modified control;

- The inherent risk associated with the related account(s) or assertion(s);

- The specific control tested prior to year end, including the nature of the control and the risk that the control is no longer effective during the remaining period, and the results of the tests of the control;

- The planned degree of reliance on the control;

- The sufficiency of the evidence of effectiveness obtained at an interim date; and

- The length of the remaining period.

31. Using Audit Evidence Obtained in Past Audits. For audits of financial statements, the auditor should obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies. When controls on which the auditor plans to rely have been tested in past audits and the auditor plans to use evidence about the effectiveness of those controls that was obtained in prior years, the auditor should take into account the following factors to determine the evidence needed during the current year audit to support the auditor's control risk assessments:

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) or assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls that the auditor has tested, especially controls that monitor other controls;
- The nature of the controls and the frequency with which they operate;

- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective);[102/]
- The complexity of the control and the significance of the judgments that must be made in connection with its operation;
- The planned degree of reliance on the control;
- The nature, timing, and extent of procedures performed in past audits;
- The results of the previous years' testing of the control;

[102/] The auditor also may use a benchmarking strategy, when appropriate, for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B28 of Auditing Standard No. 5.

- Whether there have been changes in the control or the process in which it operates since the previous audit; and

- For integrated audits, the evidence regarding the effectiveness of the controls obtained during the audit of internal control.

Assessing Control Risk

32. The auditor should assess control risk for relevant assertions by evaluating the evidence obtained from all sources, including the auditor's testing of controls for the audit of internal control and the audit of financial statements, misstatements detected during the financial statement audit, and any identified control deficiencies.

33. Control risk should be assessed at the maximum level for relevant assertions (1) for which controls necessary to sufficiently address the assessed risk of material misstatement in those assertions are missing or ineffective or (2) when the auditor has not obtained sufficient appropriate evidence to support a control risk assessment below the maximum level.

34. When deficiencies affecting the controls on which the auditor intends to rely are detected, the auditor should evaluate the severity of the deficiencies and the effect on the auditor's control risk assessments. If the auditor plans to rely on controls relating to an assertion but the controls that the auditor tests are ineffective because of control deficiencies, the auditor should:

a. Perform tests of other controls related to the same assertion as the ineffective controls, or

b. Revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased assessment of risk.

> Note: Auditing Standard No. 5 establishes requirements for evaluating the severity of a control deficiency and communicating identified control deficiencies to management and the audit committee in an integrated audit. AU sec. 325, Communications About Control Deficiencies in an Audit of Financial Statements, establishes requirements for communicating significant deficiencies and material weaknesses in an audit of financial statements only.

Testing Controls in an Audit of Internal Control

35. Auditing Standard No. 5 states that the objective of the tests of controls in an audit of internal control is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial

reporting as of a point in time and taken as a whole.[103/] Auditing Standard No. 5 establishes requirements regarding the selection of controls to be tested and the necessary nature, timing, and extent of tests of controls in an audit of internal control over financial reporting.

Substantive Procedures

36. The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.

37. As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures. Further, for an individual assertion, different combinations of the nature, timing, and extent of testing might provide sufficient appropriate evidence to respond to the assessed risk of material misstatement.

38. Internal control over financial reporting has inherent limitations,[104/] which, in turn, can affect the evidence that is needed from substantive procedures. For example, more evidence from substantive procedures ordinarily is needed for relevant assertions that

[103/] Paragraph B1 of Auditing Standard No. 5.

[104/] Paragraph A5 of Auditing Standard No. 5.

have a higher susceptibility to management override or to lapses in judgment or breakdowns resulting from human failures.[105/]

Nature of Substantive Procedures

39. Substantive procedures generally provide persuasive evidence when they are designed and performed to obtain evidence that is relevant and reliable. Also, some types of substantive procedures, by their nature, produce more persuasive evidence than others. Inquiry alone does not provide sufficient appropriate evidence to support a conclusion about a relevant assertion.

> Note: Auditing Standard No. 15 discusses certain types of substantive procedures and the relevance and reliability of audit evidence.

40. Taking into account the types of potential misstatements in the relevant assertions that could result from identified risks, as required by paragraph 9.b., can help the auditor determine the types and combination of substantive audit procedures that are necessary to detect material misstatements in the respective assertions.

41. Substantive Procedures Related to the Period-end Financial Reporting Process. The auditor's substantive procedures must include the following audit procedures related to the period-end financial reporting process:

[105/] See, e.g., paragraph .14 of AU sec. 328, Auditing Fair Value Measurements and Disclosures.

a. Reconciling the financial statements with the underlying accounting records; and

b. Examining material adjustments made during the course of preparing the financial statements.

> Note: AU secs. 316.58-.62 establish requirements for examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.

Extent of Substantive Procedures

42. The more extensively a substantive procedure is performed, the greater the evidence obtained from the procedure. The necessary extent of a substantive audit procedure depends on the materiality of the account or disclosure, the assessed risk of material misstatement, and the necessary degree of assurance from the procedure. However, increasing the extent of an audit procedure cannot adequately address an assessed risk of material misstatement unless the evidence to be obtained from the procedure is reliable and relevant.

Timing of Substantive Procedures

43. Performing certain substantive procedures at interim dates may permit early consideration of matters affecting the year-end financial statements, e.g., testing material

transactions involving higher risks of misstatement. However, performing substantive procedures at an interim date without performing procedures at a later date increases the risk that a material misstatement could exist in the year-end financial statements that would not be detected by the auditor. This risk increases as the period between the interim date and year end increases.

44. In determining whether it is appropriate to perform substantive procedures at an interim date, the auditor should take into account the following:

a. The assessed risk of material misstatement, including:

(1) The auditor's assessment of control risk, as discussed in paragraphs 32-34;

(2) The existence of conditions or circumstances, if any, that create incentives or pressures on management to misstate the financial statements between the interim test date and the end of the period covered by the financial statements;

(3) The effects of known or expected changes in the company, its environment, or its internal control over financial reporting during the remaining period;

b. The nature of the substantive procedures;

c. The nature of the account or disclosure and relevant assertion; and

d. The ability of the auditor to perform the necessary audit procedures to cover the remaining period.

45. When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. Such procedures should include (a) comparing relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual and investigating such amounts and (b) performing audit procedures to test the remaining period.

46. If the auditor obtains evidence that contradicts the evidence on which the original risk assessments were based, including evidence of misstatements that he or she did not expect, the auditor should revise the related risk assessments and modify the planned nature, timing, or extent of substantive procedures covering the remaining period as necessary. Examples of such modifications include extending or repeating at the period end the procedures performed at the interim date.

Dual-purpose Tests

47. In some situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction (a "**dual-purpose test**"). In those situations, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested.[106/]

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Dual-purpose test – Substantive test of a transaction and a test of a control relevant to that transaction that are performed concurrently, e.g., a substantive test of sales transactions performed concurrently with a test of controls over those transactions.

A3. Period of reliance – The period being covered by the company's financial statements, or the portion of that period, for which the auditor plans to rely on controls in order to modify the nature, timing, and extent of planned substantive procedures.

106/ Paragraph .44 of AU sec. 350 discusses applying audit sampling in dual-purpose tests.

Auditing Standard No. 14

Evaluating Audit Results

Introduction

1. This standard establishes requirements regarding the auditor's evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.

Objective

2. The objective of the auditor is to evaluate the results of the audit to determine whether the audit evidence obtained is sufficient and appropriate to support the opinion to be expressed in the auditor's report.

Evaluating the Results of the Audit of Financial Statements

3. In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, the auditor should take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.

4. In the audit of financial statements,[107/] the auditor's evaluation of audit results should include evaluation of the following:

a. The results of analytical procedures performed in the overall review of the financial statements ("overall review");

b. **Misstatements** accumulated during the audit, including, in particular, **uncorrected misstatements**;[108/]

c. The qualitative aspects of the company's accounting practices;

d. Conditions identified during the audit that relate to the assessment of the risk of material misstatement due to fraud ("fraud risk");

e. The presentation of the financial statements, including the disclosures; and

f. The sufficiency and appropriateness of the audit evidence obtained.

Performing Analytical Procedures in the Overall Review

5. In the overall review, the auditor should read the financial statements and disclosures and perform analytical procedures to (a) evaluate the auditor's conclusions

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[107/] For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

[108/] Terms defined in Appendix A, Definitions, are set in **boldface type** the first time they appear.

formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement.

6. As part of the overall review, the auditor should evaluate whether:

a. The evidence gathered in response to unusual or unexpected transactions, events, amounts, or relationships previously identified during the audit is sufficient; and

b. Unusual or unexpected transactions, events, amounts, or relationships[109/] indicate risks of material misstatement that were not identified previously, including, in particular, fraud risks.

> Note: If the auditor discovers a previously unidentified risk of material misstatement or concludes that the evidence gathered is not adequate, he or she should modify his or her audit procedures or perform additional procedures as necessary in accordance with paragraph 36 of this standard.

7. The nature and extent of the analytical procedures performed during the overall review may be similar to the analytical procedures performed as risk assessment

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[109/] Paragraphs 46-48 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement and paragraph .03 of AU sec. 329, Substantive Analytical Procedures.

procedures. The auditor should perform analytical procedures relating to revenue through the end of the reporting period.[110/]

8. The auditor should obtain corroboration for management's explanations regarding significant unusual or unexpected transactions, events, amounts, or relationships. If management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures to address the matter.

9. Evaluating Whether Analytical Procedures Indicate a Previously Unrecognized Fraud Risk. Whether an unusual or unexpected transaction, event, amount, or relationship indicates a fraud risk, as discussed in paragraph 6.b., depends on the relevant facts and circumstances, including the nature of the account or relationship among the data used in the analytical procedures. For example, certain unusual or unexpected transactions, events, amounts, or relationships could indicate a fraud risk if a component of the relationship involves accounts and disclosures that management has incentives or pressures to manipulate, e.g., significant unusual or unexpected relationships involving revenue and income.

[110/] Paragraph 47 of Auditing Standard No. 12 contains a requirement to perform analytical procedures relating to revenue as part of the risk assessment procedures.

Accumulating and Evaluating Identified Misstatements

10. Accumulating Identified Misstatements. The auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial.

> Note: "Clearly trivial" is not another expression for "not material." Matters that are clearly trivial will be of a smaller order of magnitude than the materiality level established in accordance with Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit, and will be inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature, or circumstances. When there is any uncertainty about whether one or more items is clearly trivial, the matter is not considered trivial.

11. The auditor may designate an amount below which misstatements are clearly trivial and do not need to be accumulated. In such cases, the amount should be set so that any misstatements below that amount would not be material to the financial statements, individually or in combination with other misstatements, considering the possibility of undetected misstatement.

12. The auditor's accumulation of misstatements should include the auditor's best estimate of the total misstatement in the accounts and disclosures that he or she has tested, not just the amount of misstatements specifically identified. This includes

misstatements related to accounting estimates, as determined in accordance with paragraph 13 of this standard, and projected misstatements from substantive procedures that involve audit sampling, as determined in accordance with AU sec. 350, Audit Sampling.[111/]

13. Misstatements Relating to Accounting Estimates. If the auditor concludes that the amount of an accounting estimate included in the financial statements is unreasonable or was not determined in conformity with the relevant requirements of the applicable financial reporting framework, he or she should treat the difference between that estimate and a reasonable estimate determined in conformity with the applicable accounting principles as a misstatement. If a range of reasonable estimates is supported by sufficient appropriate audit evidence and the recorded estimate is outside of the range of reasonable estimates, the auditor should treat the difference between the recorded accounting estimate and the closest reasonable estimate as a misstatement.

> Note: If an accounting estimate is determined in conformity with the relevant requirements of the applicable financial reporting framework and the amount of the estimate is reasonable, a difference between an estimated amount best supported by the audit evidence and the recorded amount of the accounting estimate ordinarily would not be considered to

[111/] AU sec. 350.26.

be a misstatement. Paragraph 27 discusses evaluating accounting estimates for bias.

14. Considerations as the Audit Progresses. The auditor should determine whether the overall audit strategy and audit plan need to be modified if:

a. The nature of accumulated misstatements and the circumstances of their occurrence indicate that other misstatements might exist that, in combination with accumulated misstatements, could be material; or

b. The aggregate of misstatements accumulated during the audit approaches the materiality level or levels used in planning and performing the audit.[112/]

Note: When the aggregate of accumulated misstatements approaches the materiality level or levels used in planning and performing the audit, there likely will be greater than an appropriately low level of risk that possible undetected misstatements, when combined with the aggregate of misstatements accumulated during the audit that remain uncorrected, could be material to the financial statements. If the auditor's assessment of this risk is unacceptably high,

[112/] Auditing Standard No. 11.

> he or she should perform additional audit procedures or determine that management has adjusted the financial statements so that the risk that the financial statements are materially misstated has been reduced to an appropriately low level.

15. The auditor should communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them.

16. If management has examined an account or a disclosure in response to misstatements detected by the auditor and has made corrections to the account or disclosure, the auditor should evaluate management's work to determine whether the corrections have been recorded properly and whether uncorrected misstatements remain.

17. Evaluation of the Effect of Uncorrected Misstatements. The auditor should evaluate whether uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.[113/] (See Appendix B.)

[113/] If the financial statements contain material misstatements, AU sec. 508, Reports on Audited Financial Statements, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses

Note: In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[114/] As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him …."[115/]

Note: As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility[116/] that it could lead to a material contingent liability or a material loss of

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situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

[114/] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

[115/] TSC Industries, 426 U.S. at 450.

[116/] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

revenue.[117] Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

Note: If the reevaluation of the established materiality level or levels, as set forth in Auditing Standard No. 11,[118] results in a lower amount for the materiality level or levels, the auditor should take into account that lower materiality level or levels in the evaluation of uncorrected misstatements.

18. The auditor's evaluation of uncorrected misstatements, as described in paragraph 17 of this standard, should include evaluation of the effects of uncorrected misstatements detected in prior years and misstatements detected in the current year that relate to prior years.

19. The auditor cannot assume that an instance of error or fraud is an isolated occurrence. Therefore, the auditor should evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement. This evaluation is important in determining whether the risk assessments remain appropriate, as discussed in paragraph 36 of this standard.

117/ AU sec. 317, Illegal Acts by Clients.

118/ Paragraphs 11-12 of Auditing Standard No. 11.

20. Evaluating Whether Misstatements Might Be Indicative of Fraud. The auditor should evaluate whether identified misstatements[119/] might be indicative of fraud and, in turn, how they affect the auditor's evaluation of materiality and the related audit responses. As indicated in AU sec. 316, Consideration of Fraud in a Financial Statement Audit, fraud is an intentional act that results in material misstatement of the financial statements.[120/]

21. If the auditor believes that a misstatement is or might be intentional, and if the effect on the financial statements could be material or cannot be readily determined, the auditor should perform procedures to obtain additional audit evidence to determine whether fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements and the auditor's report thereon.

22. For misstatements that the auditor believes are or might be intentional, the auditor should evaluate the implications on the integrity of management or employees and the possible effect on other aspects of the audit. If the misstatement involves higher-level management, it might be indicative of a more pervasive problem, such as an issue with the integrity of management, even if the amount of the misstatement is small. In such circumstances, the auditor should reevaluate the assessment of fraud risk and the effect of

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119/ Misstatements include omission and presentation of inaccurate or incomplete disclosures.

120/ AU sec. 316.05.

that assessment on (a) the nature, timing, and extent of the necessary tests of accounts or disclosures and (b) the assessment of the effectiveness of controls. The auditor also should evaluate whether the circumstances or conditions indicate possible collusion involving employees, management, or external parties and, if so, the effect of the collusion on the reliability of evidence obtained.

23. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, he or she also must determine his or her responsibilities under AU secs. 316.79-.82A, AU sec. 317, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1.

Evaluating the Qualitative Aspects of the Company's Accounting Practices

24. When evaluating whether the financial statements as a whole are free of material misstatement, the auditor should evaluate the qualitative aspects of the company's accounting practices, including potential bias in management's judgments about the amounts and disclosures in the financial statements.

25. The following are examples of forms of management bias:

a. The selective correction of misstatements brought to management's attention during the audit (e.g., correcting misstatements that have the effect of increasing reported earnings but not correcting misstatements that have the effect of decreasing reported earnings).

Note: To evaluate the potential effect of selective correction of misstatements, the auditor should obtain an understanding of the reasons that management decided not to correct misstatements communicated by the auditor in accordance with paragraph 15.

b. The identification by management of additional adjusting entries that offset misstatements accumulated by the auditor. If such adjusting entries are identified, the auditor should perform procedures to determine why the underlying misstatements were not identified previously and evaluate the implications on the integrity of management and the auditor's risk assessments, including fraud risk assessments. The auditor also should perform additional procedures as necessary to address the risk of further undetected misstatement.

c. Bias in the selection and application of accounting principles.[121/]

d. Bias in accounting estimates.[122/]

[121/] Paragraph 5.d. of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

[122/] Paragraph 27 of this standard.

26. If the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. Also, the auditor should evaluate whether the auditor's risk assessments, including, in particular, the assessment of fraud risks, and the related audit responses remain appropriate.

27. Evaluating Bias in Accounting Estimates. The auditor should evaluate whether the difference between estimates best supported by the audit evidence and estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the company's management. If each accounting estimate included in the financial statements was individually reasonable but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase earnings or loss, the auditor should evaluate whether these circumstances indicate potential management bias in the estimates. Bias also can result from the cumulative effect of changes in multiple accounting estimates. If the estimates in the financial statements are grouped at one end of the range of reasonable estimates in the prior year and are grouped at the other end of the range of reasonable estimates in the current year, the auditor should evaluate whether management is using swings in estimates to achieve an expected or desired outcome, e.g., to offset higher or lower than expected earnings.

Note: AU secs. 316.64-.65 establish requirements regarding performing a retrospective review of accounting estimates and evaluating the potential for fraud risks.

Evaluating Conditions Relating to the Assessment of Fraud Risks

28. When evaluating the results of the audit, the auditor should evaluate whether the accumulated results of auditing procedures[123/] and other observations affect the assessment of the fraud risks made throughout the audit and whether the audit procedures need to be modified to respond to those risks. (See Appendix C.)

29. As part of this evaluation, the engagement partner should determine whether there has been appropriate communication with the other engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks.

Note: To accomplish this communication, the engagement partner might arrange another discussion among the engagement team members about fraud risks. (See paragraphs 49-51 of Auditing Standard No. 12.)

[123/] Such auditing procedures include, but are not limited to, procedures in the overall review (paragraph 9 of this standard), the evaluation of identified misstatements (paragraphs 20-23 of this standard), and the evaluation of the qualitative aspects of the company's accounting practices (paragraphs 24-27 of this standard).

Evaluating the Presentation of the Financial Statements, Including the Disclosures

30. The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

> Note: AU sec. 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles, establishes requirements for evaluating the presentation of the financial statements. Auditing Standard No. 6, Evaluating Consistency of Financial Statements, establishes requirements regarding evaluating the consistency of the accounting principles used in financial statements.

> Note: The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

31. As part of the evaluation of the presentation of the financial statements, the auditor should evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework. Evaluation of the information disclosed in the financial statements includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the

terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

> Note: According to AU sec. 508, if the financial statements, including the accompanying notes, fail to disclose information that is required by the applicable financial reporting framework, the auditor should express a qualified or adverse opinion and should provide the information in the report, if practicable, unless its omission from the report is recognized as appropriate by a specific auditing standard.[124/]

Evaluating the Sufficiency and Appropriateness of Audit Evidence

32. Auditing Standard No. 8, Audit Risk, states:

> To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through

124/ AU secs. 508.41-.44.

applying due professional care, including obtaining sufficient appropriate audit evidence.[125]

33. As part of evaluating audit results, the auditor must conclude on whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements.

34. Factors that are relevant to the conclusion on whether sufficient appropriate audit evidence has been obtained include the following:

a. The significance of uncorrected misstatements and the likelihood of their having a material effect, individually or in combination, on the financial statements, considering the possibility of further undetected misstatement (paragraphs 14 and 17-19 of this standard).

b. The results of audit procedures performed in the audit of financial statements, including whether the evidence obtained supports or contradicts management's assertions and whether such audit procedures identified specific instances of fraud (paragraphs 20-23 and 28-29 of this standard).

c. The auditor's risk assessments (paragraph 36 of this standard).

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[125] Paragraph 3 of Auditing Standard No. 8.

d. The results of audit procedures performed in the audit of internal control over financial reporting, if the audit is an integrated audit.

e. The appropriateness (i.e., the relevance and reliability) of the audit evidence obtained.[126/]

35. If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion or has substantial doubt about a relevant assertion, the auditor should perform procedures to obtain further audit evidence to address the matter. If the auditor is unable to obtain sufficient appropriate audit evidence to have a reasonable basis to conclude about whether the financial statements as a whole are free of material misstatement, AU sec. 508 indicates that the auditor should express a qualified opinion or a disclaimer of opinion.[127/]

36. Evaluating the Appropriateness of Risk Assessments. As part of the evaluation of whether sufficient appropriate audit evidence has been obtained, the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate and whether the audit procedures need to be modified or additional procedures need to be performed as a result of any changes in the risk

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[126/] Paragraphs 7-9 of Auditing Standard No. 15, Audit Evidence, discuss the relevance and reliability of audit evidence.

[127/] AU sec. 508.22-.34 contains requirements regarding audit scope limitations.

assessments. For example, the re-evaluation of the auditor's risk assessments could result in the identification of relevant assertions or significant risks that were not identified previously and for which the auditor should perform additional audit procedures.

> Note: Auditing Standard No. 12 establishes requirements on revising the auditor's risk assessment.[128/] Auditing Standard No. 13 discusses the auditor's responsibilities regarding the assessment of control risk and evaluation of control deficiencies in an audit of financial statements.[129/]

Evaluating the Results of the Audit of Internal Control Over Financial Reporting

37. Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, indicates that the auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit, and any identified control deficiencies. Auditing Standard No. 5 describes the auditor's responsibilities regarding

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128/ Paragraph 74 of Auditing Standard No. 12.

129/ Paragraphs 32-34 of Auditing Standard No. 13.

evaluating the results of the audit, including evaluating the identified control deficiencies.[130/]

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Misstatement – A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework.[131/] A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework. Misstatements can arise from error (i.e., unintentional misstatement) or fraud.[132/]

[130/] Paragraphs 62-70 of Auditing Standard No. 5 discuss evaluating identified control deficiencies, and paragraphs 71-73 of Auditing Standard No. 5 discuss forming an opinion on the effectiveness of internal control over financial reporting.

[131/] The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

[132/] Paragraph .02 of AU sec. 316, Consideration of Fraud in a Financial Statement Audit.

A3. Uncorrected misstatements – Misstatements, other than those that are clearly trivial,[133/] that management has not corrected.

<u>APPENDIX B</u> – Qualitative Factors Related to the Evaluation of the Materiality of Uncorrected Misstatements

B1. Paragraph 17 of this standard states:

> The auditor should evaluate whether uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.[134/]
>
> > Note: In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total

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[133/] Paragraph 10 of this standard states that, "[t]he auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial."

[134/] If the financial statements contain material misstatements, AU sec. 508, <u>Reports on Audited Financial Statements</u>, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

mix' of information made available."[135/] As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him …."[136/]

Note: As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility[137/] that it could lead to a material contingent liability or a material loss of revenue.[138/] Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

[135/] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

[136/] TSC Industries, 426 U.S. at 450.

[137/] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

[138/] AU sec. 317, Illegal Acts by Clients.

B2. Qualitative factors to consider in the auditor's evaluation of the materiality of uncorrected misstatements, if relevant, include the following:

a. The potential effect of the misstatement on trends, especially trends in profitability.

b. A misstatement that changes a loss into income or vice versa.

c. The effect of the misstatement on segment information, for example, the significance of the matter to a particular segment important to the future profitability of the company, the pervasiveness of the matter on the segment information, and the impact of the matter on trends in segment information, all in relation to the financial statements taken as a whole.

d. The potential effect of the misstatement on the company's compliance with loan covenants, other contractual agreements, and regulatory provisions.

e. The existence of statutory or regulatory reporting requirements that affect materiality thresholds.

f. A misstatement that has the effect of increasing management's compensation, for example, by satisfying the requirements for the award of bonuses or other forms of incentive compensation.

g. The sensitivity of the circumstances surrounding the misstatement, for example, the implications of misstatements involving fraud and possible illegal acts, violations of contractual provisions, and conflicts of interest.

h. The significance of the financial statement element affected by the misstatement, for example, a misstatement affecting recurring earnings as contrasted to one involving a non-recurring charge or credit, such as an extraordinary item.

i. The effects of misclassifications, for example, misclassification between operating and non-operating income or recurring and non-recurring income items.

j. The significance of the misstatement or disclosures relative to known user needs, for example:

- The significance of earnings and earnings per share to public company investors.

- The magnifying effects of a misstatement on the calculation of purchase price in a transfer of interests (buy/sell agreement).

- The effect of misstatements of earnings when contrasted with expectations.

k. The definitive character of the misstatement, for example, the precision of an error that is objectively determinable as contrasted with a misstatement that unavoidably involves a degree of subjectivity through estimation, allocation, or uncertainty.

l. The motivation of management with respect to the misstatement, for example, (i) an indication of a possible pattern of bias by management when developing and accumulating accounting estimates or (ii) a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process.

m. The existence of offsetting effects of individually significant but different misstatements.

n. The likelihood that a misstatement that is currently immaterial may have a material effect in future periods because of a cumulative effect, for example, that builds over several periods.

o. The cost of making the correction − it may not be cost-beneficial for the client to develop a system to calculate a basis to record the effect of an immaterial misstatement. On the other hand, if management appears to have developed a system to calculate an amount that represents an immaterial misstatement, it may reflect a motivation of management as noted in paragraph B2.l above.

p. The risk that possible additional undetected misstatements would affect the auditor's evaluation.

<u>APPENDIX C</u> – Matters That Might Affect the Assessment of Fraud Risks

C1. If the following matters are identified during the audit, the auditor should take into account these matters in the evaluation of the assessment of fraud risks, as discussed in paragraph 28 of this standard:

a. Discrepancies in the accounting records, including:

(1) Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or company policy.

(2) Unsupported or unauthorized balances or transactions.

(3) Last-minute adjustments that significantly affect financial results.

(4) Evidence of employees' access to systems and records that is inconsistent with the access that is necessary to perform their authorized duties.

(5) Tips or complaints to the auditor about alleged fraud.

b. Conflicting or missing evidence, including:

(1) Missing documents.

(2) Documents that appear to have been altered.[139/]

(3) Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.

(4) Significant unexplained items in reconciliations.

(5) Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.

(6) Unusual discrepancies between the company's records and confirmation responses.

(7) Missing inventory or physical assets of significant magnitude.

(8) Unavailable or missing electronic evidence that is inconsistent with the company's record retention practices or policies.

[139/] Paragraph 9 of Auditing Standard No. 15, Audit Evidence.

(9) Inability to produce evidence of key systems development and program change testing and implementation activities for current year system changes and deployments.

(10) Unusual balance sheet changes or changes in trends or important financial statement ratios or relationships, e.g., receivables growing faster than revenues.

(11) Large numbers of credit entries and other adjustments made to accounts receivable records.

(12) Unexplained or inadequately explained differences between the accounts receivable subsidiary ledger and the general ledger control account, or between the customer statement and the accounts receivable subsidiary ledger.

(13) Missing or nonexistent cancelled checks in circumstances in which cancelled checks are ordinarily returned to the company with the bank statement.

(14) Fewer responses to confirmation requests than anticipated or a greater number of responses than anticipated.

c. Problematic or unusual relationships between the auditor and management, including:

(1) Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought, including:[140/]

a. Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.

b. Denial of access to key information technology operations staff and facilities, including security, operations, and systems development.

(2) Undue time pressures imposed by management to resolve complex or contentious issues.

(3) Management pressure on engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.

[140/] Denial of access to information might constitute a limitation on the scope of the audit that requires the auditor to qualify or disclaim an opinion. (See Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, and AU sec. 508, Reports on Audited Financial Statements.)

(4) Unusual delays by management in providing requested information.

(5) Management's unwillingness to add or revise disclosures in the financial statements to make them more complete and transparent.

(6) Management's unwillingness to appropriately address significant deficiencies in internal control on a timely basis.

d. Other matters, including:

(1) Objections by management to the auditor meeting privately with the audit committee.

(2) Accounting policies that appear inconsistent with industry practices that are widely recognized and prevalent.

(3) Frequent changes in accounting estimates that do not appear to result from changing circumstances.

(4) Tolerance of violations of the company's code of conduct.

Auditing Standard No. 15

Audit Evidence

Introduction

1. This standard explains what constitutes audit evidence and establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.

2. Audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and information that contradicts such assertions.

Objective

3. The objective of the auditor is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report.[141/]

[141/] Auditing Standard No. 14, Evaluating Audit Results, establishes requirements regarding evaluating whether sufficient appropriate evidence has been obtained. Auditing Standard No. 3, Audit Documentation, establishes requirements regarding documenting the procedures performed, evidence obtained, and conclusions reached in an audit.

Sufficient Appropriate Audit Evidence

4. The auditor must plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion.

5. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the following:

- Risk of material misstatement (in the audit of financial statements) or the risk associated with the control (in the audit of internal control over financial reporting). As the risk increases, the amount of evidence that the auditor should obtain also increases. For example, ordinarily more evidence is needed to respond to significant risks.[142/]

- Quality of the audit evidence obtained. As the quality of the evidence increases, the need for additional corroborating evidence decreases. Obtaining more of the same type of audit evidence, however, cannot compensate for the poor quality of that evidence.

6. Appropriateness is the measure of the quality of audit evidence, i.e., its relevance and reliability. To be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based.

[142/] Paragraph A5 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

Relevance and Reliability

7. Relevance. The relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The relevance of audit evidence depends on:

a. The design of the audit procedure used to test the assertion or control, in particular whether it is designed to (1) test the assertion or control directly and (2) test for understatement or overstatement; and

b. The timing of the audit procedure used to test the assertion or control.

8. Reliability. The reliability of evidence depends on the nature and source of the evidence and the circumstances under which it is obtained. For example, in general:

- Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources.

- The reliability of information generated internally by the company is increased when the company's controls over that information are effective.

- Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.

- Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized, or otherwise converted into electronic form, the reliability of which depends on the controls over the conversion and maintenance of those documents.

9. The auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should evaluate the effect, if any, on the other aspects of the audit.

Using Information Produced by the Company

10. When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to:[143/]

[143/] When using the work of a specialist engaged or employed by management, see AU sec. 336, Using the Work of a Specialist. When using information produced by a service organization or a service auditor's report as audit evidence, see AU sec. 324, Service Organizations, and for integrated audits, see Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

- Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and
- Evaluate whether the information is sufficiently precise and detailed for purposes of the audit.

Financial Statement Assertions

11. In representing that the financial statements are presented fairly in conformity with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of financial statements and related disclosures. Those assertions can be classified into the following categories:

- Existence or occurrence – Assets or liabilities of the company exist at a given date, and recorded transactions have occurred during a given period.
- Completeness – All transactions and accounts that should be presented in the financial statements are so included.
- Valuation or allocation – Asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts.

- Rights and obligations – The company holds or controls rights to the assets, and liabilities are obligations of the company at a given date.

- Presentation and disclosure – The components of the financial statements are properly classified, described, and disclosed.

12. The auditor may base his or her work on financial statement assertions that differ from those in this standard if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement in each significant account and disclosure that has a reasonable possibility[144/] of containing misstatements that would cause the financial statements to be materially misstated, individually or in combination with other misstatements.[145/]

Audit Procedures for Obtaining Audit Evidence

13. Audit procedures can be classified into the following categories:

a. Risk assessment procedures,[146/] and

[144/] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

[145/] For an integrated audit, also see paragraph 28 of Auditing Standard No. 5.

[146/] Auditing Standard No. 12.

b. Further audit procedures,[147/] which consist of:

(1) Tests of controls, and

(2) Substantive procedures, including tests of details and substantive analytical procedures.

14. Paragraphs 15-21 of this standard describe specific audit procedures. The purpose of an audit procedure determines whether it is a risk assessment procedure, test of controls, or substantive procedure.

Inspection

15. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or physically examining an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorization.

[147/] Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

Observation

16. Observation consists of looking at a process or procedure being performed by others, e.g., the auditor's observation of inventory counting by the company's personnel or the performance of control activities. Observation can provide audit evidence about the performance of a process or procedure, but the evidence is limited to the point in time at which the observation takes place and also is limited by the fact that the act of being observed may affect how the process or procedure is performed.[148/]

Inquiry

17. Inquiry consists of seeking information from knowledgeable persons in financial or nonfinancial roles within the company or outside the company. Inquiry may be performed throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.[149/]

> Note: Inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level

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[148/] AU sec. 331, Inventories, establishes requirements regarding observation of the counting of inventory.

[149/] AU sec. 333, Management Representations, establishes requirements regarding written management representations, including confirmation of management responses to oral inquiries.

for a relevant assertion or to support a conclusion about the effectiveness of a control.

Confirmation

18. A confirmation response represents a particular form of audit evidence obtained by the auditor from a third party in accordance with PCAOB standards.[150/]

Recalculation

19. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Reperformance

20. Reperformance involves the independent execution of procedures or controls that were originally performed by company personnel.

Analytical Procedures

21. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical

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[150/] AU sec. 330, The Confirmation Process.

procedures also encompass the investigation of significant differences from expected amounts.[151/]

Selecting Items for Testing to Obtain Audit Evidence

22. Designing substantive tests of details and tests of controls includes determining the means of selecting items for testing from among the items included in an account or the occurrences of a control. The auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. The alternative means of selecting items for testing are:

- Selecting all items;
- Selecting specific items; and
- Audit sampling.

23. The particular means or combination of means of selecting items for testing that is appropriate depends on the nature of the audit procedure, the characteristics of the control or the items in the account being tested, and the evidence necessary to meet the objective of the audit procedure.

151/ AU sec. 329, Substantive Analytical Procedures, establishes requirements on performing analytical procedures as substantive procedures.

Selecting All Items

24. Selecting all items (100 percent examination) refers to testing the entire population of items in an account or the entire population of occurrences of a control (or an entire stratum within one of those populations). The following are examples of situations in which 100 percent examination might be applied:

- The population constitutes a small number of large value items;
- The audit procedure is designed to respond to a significant risk, and other means of selecting items for testing do not provide sufficient appropriate audit evidence; and
- The audit procedure can be automated effectively and applied to the entire population.

Selecting Specific Items

25. Selecting specific items refers to testing all of the items in a population that have a specified characteristic, such as:

- <u>Key items</u>. The auditor may decide to select specific items within a population because they are important to accomplishing the objective of the audit procedure or exhibit some other characteristic, e.g., items that are suspicious, unusual, or particularly risk-prone or items that have a history of error.

- All items over a certain amount. The auditor may decide to examine items whose recorded values exceed a certain amount to verify a large proportion of the total amount of the items included in an account.

26. The auditor also might select specific items to obtain an understanding about matters such as the nature of the company or the nature of transactions.

27. The application of audit procedures to items that are selected as described in paragraphs 25-26 of this standard does not constitute audit sampling, and the results of those audit procedures cannot be projected to the entire population.[152/]

Audit Sampling

28. Audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.[153/]

[152/] If misstatements are identified in the selected items, see paragraphs 12-13 and paragraphs 17-19 of Auditing Standard No. 14.

[153/] AU sec. 350, Audit Sampling, establishes requirements regarding audit sampling.

Inconsistency in, or Doubts about the Reliability of, Audit Evidence

29. If audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

Conforming Amendment to PCAOB Interim Quality Control Standards

Auditing Standards

AU sec. 110, "Responsibilities and Functions of the Independent Auditor"

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures" section 110, "Responsibilities and Functions of the Independent Auditor" (AU sec. 110, "Responsibilities and Functions of the Independent Auditor"), as amended, is amended as follows:

> Within footnote 1 to paragraph .02, the reference to section 312, Audit Risk and Materiality in Conducting an Audit, is replaced with a reference to Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit.

AU sec. 150, "Generally Accepted Auditing Standards"

SAS No. 95, "Generally Accepted Auditing Standards" (AU sec. 150, "Generally Accepted Auditing Standards"), as amended, is amended as follows:

a. Within paragraph .02, in the third standard of field work, the word "competent" is replaced with the word "appropriate."

b. Footnote 2 to paragraph .04 is deleted.

AU sec. 210, "Training and Proficiency of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 210, "Training and Proficiency of the Independent Auditor" (AU sec. 210, "Training and Proficiency of the Independent Auditor "), as amended, is amended as follows:

The last sentence of paragraph .03 is replaced with:

> The engagement partner must exercise seasoned judgment in the varying degrees of his supervision and review of the work done and judgments exercised by his subordinates, who in turn must meet the responsibilities attaching to the varying gradations and functions of their work.

AU sec. 230, "Due Professional Care in the Performance of Work"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 230, "Due Professional Care in the Performance of Work" (AU sec. 230, "Due Professional Care in the Performance of Work"), as amended, is amended as follows:

a. The second and third sentences of paragraph .06 are replaced with:

The engagement partner should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client. The engagement partner is responsible for the assignment of tasks to, and supervision of, the members of the engagement team.[fn4]

b. Footnote 3 to paragraph .06 is deleted.

c. Within footnote 4 to paragraph .06, the phrase "See section 311.11" is replaced with, "See Auditing Standard No. 10, Supervision of the Audit Engagement."

d. Footnote 6 to paragraph .11 is deleted.

e. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

f. At the end of the fifth sentence of paragraph .12, the following parenthetical is added: "(See paragraph 9 of Auditing Standard No. 15, Audit Evidence.)"

AU sec. 310, "Appointment of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 310, "Appointment of the Independent Auditor" (AU sec. 310, "Appointment of the Independent Auditor"), as amended, is amended as follows:

a. Within footnote ** to the title of the standard, the sentence "(See section 313.)" is deleted.

b. Paragraph .02 is replaced with:

   Audit planning is discussed in Auditing Standard No. 9, Audit Planning, and supervision of engagement team members is discussed in Auditing Standard No. 10, Supervision of the Audit Engagement.

c. In paragraph .03, the sentence "(See section 313)" is deleted.

d. Within footnote 3 to paragraph .06, the reference to Section 312, Audit Risk and Materiality in Conducting an Audit, paragraph .04, is replaced with a reference to Paragraph A2 of Auditing Standard No. 14, Evaluating Audit Results.

AU sec. 311, "Planning and Supervision"

SAS No. 22, "Planning and Supervision" (AU sec. 311, "Planning and Supervision"), as amended, is superseded.

AU sec. 9311, "Planning and Supervision: Auditing Interpretations of Section 311"

AU sec. 9311, "Planning and Supervision: Auditing Interpretations of Section 311", as amended, is superseded.

AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"

SAS No. 47, "Audit Risk and Materiality in Conducting an Audit" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), as amended, is superseded.

AU sec. 9312, "Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312"

AU sec. 9312, "Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312" is superseded.

AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"

SAS No. 45, "Omnibus Statement on Auditing Standards – 1983" (AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"), as amended, is superseded.

AU sec. 315, "Communications Between Predecessor and Successor Auditors"

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows:

a. In the first sentence of paragraph .12, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .18, the word "competent" is replaced with the word "appropriate."

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

a. The second sentence of paragraph .01 is replaced with:

    This section establishes requirements and provides direction relevant to fulfilling that responsibility, as it relates to fraud, in an audit of financial statements. [fn 2]

b. In footnote 1 to paragraph .01, delete the following information: (see section 312, Audit Risk and Materiality in Conducting an Audit," and the closing parenthesis at the end of that sentence.

c. Footnote 2 to paragraph .01 is replaced with:

For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

d. The following paragraph .01A is added:

Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements. Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement. Auditing Standard No. 14, Evaluating Audit Results, establishes requirements regarding the auditor's evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.

e. In paragraph .02:

- The third through the sixth bullet points are deleted.
- The seventh bullet point is replaced with:

  Responding to fraud risks

. This section discusses certain responses to fraud risks involving the nature, timing, and extent of audit procedures, including:

- Responses to assessed fraud risks relating to fraudulent financial reporting and misappropriation of assets (see paragraphs .52 through .56).
- Responses to specifically address the fraud risks arising from management override of internal controls (see paragraphs .57 through .67).

- The eighth bullet point is deleted.

f. Paragraph .03 is deleted.

g. Footnote 5 to paragraph .06 is replaced with:

The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

h. In the third sentence of paragraph .13, the term "the risk of material misstatement due to fraud" is replaced with the term "fraud risks."

i. Paragraphs .14 through .45 are deleted, along with the preceding heading, "Discussion Among Engagement Personnel Regarding the Risks of

Material Misstatement Due to Fraud."

j. Footnotes 8 through 19 related to paragraphs .14 through .45 are deleted.

k. Paragraphs .46 through .50 are deleted. The heading preceding paragraph .46, "Responding to the Results of the Assessment," is replaced with the heading "Responding to Assessed Fraud Risks."

l. Paragraph .51 is deleted. The heading preceding paragraph .51, "Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed to Address the Identified Risks," is replaced with the heading "Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed."

m. Paragraph .52 is replaced with:

Paragraph 8 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, states that "[t]he auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement due to error or fraud for each relevant assertion of each significant account and disclosure." Paragraph 12 of Auditing Standard No. 13 states that "the audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected."

Note: Paragraph 71.b. of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, states that a fraud risk is a significant risk. Accordingly, the requirement for responding to significant risks also applies to fraud risks.

n. In paragraph .53:

- The first sentence is replaced with:

  The following are examples of responses to assessed fraud risks involving the nature, timing, and extent of audit procedures:

- The fifth bullet point is replaced with:

  Interviewing personnel involved in activities in areas in which a fraud risk has been identified to obtain their insights about the risk and how controls address the risk. (See paragraph 54 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement)

- In the sixth bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

o. Footnote 20 to paragraph .53 is replaced with:

AU sec. 329, Substantive Analytical Procedures, establishes requirements regarding performing analytical procedures as substantive tests.

p. The heading preceding paragraph .54, "Additional Examples of Responses to Identified Risks of Misstatements Arising From Fraudulent Financial Reporting," is replaced with the heading "Additional Examples of Audit Procedures Performed to Respond to Assessed Fraud Risks Relating to Fraudulent Financial Reporting."

q. The first sentence in paragraph .54 is replaced with:

The following are additional examples of audit procedures that might be performed in response to assessed fraud risks relating to fraudulent financial reporting:

r. In paragraph .54:

- In the last sentence of the first bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- In the first sentence of the second bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- In the first sentence of the third bullet point and the accompanying paragraph to the third bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

s. Footnotes 21 and 22 to paragraph .54 are amended as follows:

- The text of footnote 21 is replaced with "AU sec. 330, The Confirmation Process, establishes requirements regarding the confirmation process in audits of financial statements."

- The text of footnote 22 is replaced with "AU sec. 336, Using the Work of a Specialist, establishes requirements for an auditor who uses the work of a specialist in performing an audit of financial statements."

t. The heading preceding paragraph .55, "Examples of Responses to Identified Risks of Misstatements Arising From Misappropriations of Assets," is replaced with the heading "Examples of Audit Procedures Performed to Respond to Fraud Risks Relating to Misappropriations of Assets."

u. In the first sentence of paragraph .55, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

v. In paragraph .56:

- The first and second sentences are replaced with:

  The audit procedures performed in response to a fraud risk relating to misappropriation of assets usually will be directed toward certain account balances. Although some of the audit procedures noted in paragraphs .53 and .54 and in paragraphs 8 through 15 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, may apply in such circumstances, such as the procedures directed at inventory quantities, the scope of the work should be linked to the specific information about the misappropriation risk that has been identified.

- In the third sentence, the words "design and" are added before the words "operating effectiveness."

w. The heading preceding paragraph .57, "Responses to Further Address the Risk of Management Override of Controls," is replaced with the heading "Audit Procedures Performed to Specifically Address the Risk of Management Override of Controls."

x. The third sentence of paragraph .57 is replaced with:

Accordingly, as part of the auditor's responses that address fraud risks, the procedures described in paragraphs .58 through .67 should be performed to specifically address the risk of management override of controls.

y. Footnote 23 to paragraph .58 is replaced with:

See paragraphs 28 through 32 of Auditing Standard No. 12, <u>Identifying and Assessing Risks of Material Misstatement</u>.

z. In paragraph .61:

- In the first sentence of the first bullet point, the term "the risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- In the second bullet point, the last two sentences are replaced with the following:

  Effective controls over the preparation and posting of journal entries and adjustments may affect the extent of substantive testing necessary, provided that the auditor has tested the controls. However, even though controls might be implemented and operating effectively, the auditor's substantive procedures for testing journal entries and other adjustments should include the identification and substantive testing of specific items.

- In item (f) of the fifth bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- The last sentence of the fifth bullet point is replaced with:

  In audits of entities that have multiple locations or business units, the auditor should determine whether to select journal entries from locations based on factors set forth in paragraphs 11 through 14 of Auditing Standard No. 9, Audit Planning.

aa. The last sentence of paragraph .63 is replaced with:

Paragraphs 24 through 27 of Auditing Standard No. 14, Evaluating Audit Results, discuss the auditor's responsibilities for assessing bias in accounting estimates and the effect of bias on the financial statements.

bb. Paragraphs .68 through .78 are deleted, along with the preceding heading "Evaluating Audit Evidence."

cc. Footnotes 26 through 36 related to paragraphs .68 through .78 are deleted.

dd. In the first sentence of paragraph .80, the term "risks of material misstatement due to fraud" is replaced with the term "fraud risks."

ee. The last sentence of paragraph .80 is replaced with:

The auditor also should evaluate whether the absence of or deficiencies in controls that address fraud risks or otherwise help prevent, deter, and detect fraud (see paragraphs 72-73 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement) represent significant deficiencies or material weaknesses that should be communicated to senior management and the audit committee.

ff. The first sentence of paragraph .81 is replaced with:

The auditor also should consider communicating other fraud risks, if any, identified by the auditor.

gg. In paragraph .83:

- The reference in the first bullet point to paragraphs .14 through .17 is replaced with a reference to paragraphs 52 and 53 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

- The term "risks of material misstatement due to fraud" in the first sentence of the second bullet point is replaced with the term "fraud risks." The reference in the second bullet point to paragraphs .19 through .34 is replaced with references to paragraph 47, paragraphs

56 through 58, and paragraphs 65 through 69 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

- The third bullet point is replaced with:

  The fraud risks that were identified at the financial statement and assertion levels (see paragraphs 59 through 69 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement), and the linkage of those risks to the auditor's response (see paragraphs 5 through 15 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement).

- Within the fourth bullet point, the term "risk of material misstatement due to fraud" in the first sentence is replaced with the term "fraud risk," and the reference to paragraph .41 is replaced with a reference to paragraph 68 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

- The fifth bullet point is replaced with:

  The results of the procedures performed to address the assessed fraud risks, including those procedures performed to further address the risk of management override of controls (See paragraph 15 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatements.)

- The reference in the sixth bullet point to paragraphs .68 through .73 is replaced with a reference to paragraphs 5 through 9 of Auditing Standard No. 14, Evaluating Audit Results.

hh. Paragraph .84 and the heading preceding this paragraph, "Effective Date," are deleted.

ii. The first sentence of paragraph .85 is replaced with:

This appendix contains examples of risk factors discussed in paragraphs 65 through 69 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

AU sec. 317, "Illegal Acts by Clients"

SAS No. 54, "Illegal Acts by Clients" (AU sec. 317, "Illegal Acts by Clients") is amended as follows:

a. The last sentence of paragraph .13 is replaced with:

For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

b. In paragraph .19, the word "competent" is replaced with the word "appropriate."

<u>AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"</u>

SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), as amended, is superseded.

<u>AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"</u>

SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), as amended, is amended as follows:

a. In the first sentence of paragraph .02, the word "competent" is replaced with the word "appropriate."

b. Footnote 3 to paragraph .04, is replaced with:

Auditing Standard No. 12, <u>Identifying and Assessing Risks of Material Misstatement</u>, describes the procedures the auditor performs to obtain an understanding of internal control over financial reporting.

c. In the first sentence of paragraph .18, the word "competent" is replaced with the word "appropriate."

d. Within footnote 5 to paragraph .18, the reference to section 326, Evidential Matter, paragraph .19c. is replaced with a reference to paragraph 8 of Auditing Standard No. 15, Audit Evidence.

e. Within footnote 8 to paragraph .27, the reference to section 311, Planning and Supervision, paragraphs .11 through .14 is replaced with a reference to Auditing Standard No. 10, Supervision of the Audit Engagement.

AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations" (AU sec. 324, "Service Organizations"), as amended, is amended as follows:

a. In the first sentence of paragraph .07, the reference to Section 319, Consideration of Internal Control in a Financial Statement Audit, is replaced with a reference to Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

b. In the first sentence of paragraph .16, the reference to section 319.90 through .99 is replaced with a reference to paragraph 18 and paragraphs 29 through 31 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

c. In the second sentence of paragraph .23, the reference to section 312, Audit Risk and Materiality in Conducting an Audit, is replaced with a reference to Auditing Standard No. 14, Evaluating Audit Results.

AU sec. 326, "Evidential Matter"

SAS No. 31, "Evidential Matter" (AU sec. 326, "Evidential Matter"), as amended, is superseded.

AU sec. 9326, "Evidential Matter: Auditing Interpretations of Section 326"

AU sec. 9326, "Evidential Matter: Auditing Interpretations of Section 326," as amended, is amended as follows:

a. Paragraphs .01-.05 are deleted, along with the preceding heading "1. Evidential Matter for an Audit of Interim Financial Statements."

b. The reference in paragraph .10 to Section 326, Evidential Matter, paragraph .25, is replaced with a reference to Paragraph 35 of Auditing Standard No. 14, Evaluating Audit Results.

c. In the first and second sentences of paragraph .10, the word "competent" is replaced with the word "appropriate."

d. In the second sentence of paragraph .12, the word "competent" is replaced with the word "appropriate."

e. The last two sentences of paragraph .12 are deleted.

f. In the first sentence of paragraph .13, the word "competent" is replaced with the word "appropriate."

g. In paragraph .17, the word "competent" is replaced with the word "appropriate."

h. In the second sentence of paragraph .21, the word "competent" is replaced with the word "appropriate."

i. In the fourth sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."

j. In paragraph .23, the word "competent" is replaced with the word "appropriate."

k. Paragraphs .24-.41 are deleted, along with the headings "3. The Auditor's Consideration of the Completeness Assertion" and "4. Applying Auditing Procedures to Segment Disclosures in Financial Statements."

<u>AU sec. 328, "Auditing Fair Value Measurements and Disclosures"</u>

SAS No. 101, "Auditing Fair Value Measurements and Disclosures" (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), as amended, is amended as follows:

a. In the first sentence of paragraph .03, the word "competent" is replaced with the word "appropriate."

b. The phrase in paragraph .11 "Section 319, Consideration of Internal Control in a Financial Statement Audit, as amended," is replaced with "Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement,"

c. The reference in paragraph .14 to Section 319 is replaced with a reference to Paragraph A5, second note of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

d. In the second sentence of paragraph .14, the reference "(see section 316, Consideration of Fraud in a Financial Statement Audit" is deleted.

e. Within paragraph .25, in the second sentence of the second bullet point and in the first sentence in the third bullet point, the word "competent" is replaced with the word "appropriate."

f. In the second sentence of paragraph .32, the word "competent" is replaced with the word "appropriate."

g. In the first sentence of paragraph .42, the word "competent" is replaced with the word "appropriate."

h. In footnote 8 to paragraph .43, the reference to section 431, Adequacy of Disclosure in Financial Statements, is replaced with a reference to "paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results."

i. In the second sentence of paragraph .44, the word "competent" is replaced with the word "appropriate."

j. The reference in paragraph .47 to section 312, Audit Risk and Materiality in Conducting an Audit, paragraphs .36 through .41, is replaced with a reference to paragraphs 12 through 18 and 24 through 27 of Auditing Standard No. 14, Evaluating Audit Results.

AU sec. 329, "Analytical Procedures"

SAS No. 56, "Analytical Procedures" (AU sec. 329, "Analytical Procedures"), as amended, is amended as follows:

a. The title of the standard, "Analytical Procedures," is replaced with the title, "Substantive Analytical Procedures."

b. The text of paragraph .01 is replaced with:

This section establishes requirements regarding the use of substantive analytical procedures in an audit.

Note: Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, establishes requirements regarding performing analytical procedures as a risk assessment procedure in identifying and assessing risks of material misstatement.

Note: Auditing Standard No. 14, Evaluating Audit Results, establishes requirements regarding performing analytical procedures as part of the overall review stage of the audit.

c. The last sentence of paragraph .03 is deleted.

d. The text of paragraph .04 is replaced with:

Analytical procedures are used as a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions. In some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

e. Paragraphs .06-.08 and the preceding heading, "Analytical Procedures in Planning the Audit," are deleted.

f. At the end of paragraph .09, the following new sentence is added:

(See paragraph 11 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.)

g. Within footnote 1 to paragraph .09, the reference to section 326, Evidential Matter, is replaced with a reference to Auditing Standard No. 15, Audit Evidence.

h. Footnote 2 to paragraph .20 is deleted.

i. In paragraph .21:

- In the fourth sentence, the word "likely" is deleted.
- The reference to section 316, Consideration of Fraud in a Financial Statement Audit, is replaced with a reference to Auditing Standard No. 14, Evaluating Audit Results.

j. Footnote 3 to paragraph .21 is deleted.

k. Paragraph .23 and the preceding heading, "Analytical Procedures Used in the Overall Review," and paragraph .24 and the preceding heading, "Effective Date," are deleted.

AU sec. 330, "The Confirmation Process"

SAS No. 67, "The Confirmation Process" (AU sec. 330, "The Confirmation

Process"), is amended as follows:

a. The references in paragraph .02 to section 312, Audit Risk and Materiality in Conducting an Audit, and section 313, Substantive Tests Prior to the Balance-Sheet Date, are replaced with a reference to Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

b. The reference in paragraph .05 to Section 312 is replaced with a reference to Auditing Standard No. 8, Audit Risk.

c. The second sentence of paragraph .06 is replaced with:

   See paragraph 8 of Auditing Standard No. 15, Audit Evidence, which discusses the reliability of audit evidence.

d. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

e. In the third sentence of paragraph .11, the reference to Section 326 is replaced with a reference to Auditing Standard No. 15, Audit Evidence.

f. In the first sentence of paragraph .24, the word "competence" is replaced with the word "appropriateness."

g. In the last sentence of paragraph .27, the word "competent" is replaced with the word "appropriate."

AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"

SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investment in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), as amended, is amended as follows:

a. The reference in paragraph .01 to section 326, Evidential Matter, paragraphs .03 – .08, is replaced with a reference to paragraphs 11 and 12 of Auditing Standard No. 15, Audit Evidence.

b. Paragraph .06 is replaced with:

Auditing Standard No. 9, Audit Planning, discusses the auditor's responsibilities for consideration of the use of persons with specialized skill or knowledge. Auditing Standard No. 10, Supervision of the Audit Engagement, discusses the auditor's responsibilities for supervision of specialists who are employed by the auditor. AU sec. 336, Using the Work of a Specialist, discusses the auditor's responsibilities for using the work of a specialist engaged by the auditor.

c. The first and second sentences of paragraph .07 are deleted. The third sentence is replaced with:

The auditor should design and perform audit procedures regarding relevant assertions of derivatives and investments in securities that are based on and that address the risks of material misstatement in those assertions.

d. The reference in paragraph .09 to Section 319, Consideration of Internal Control in a Financial Statement Audit, is replaced with a reference to Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

e. The fourth sentence of paragraph .11 is replaced with "Paragraphs 28 through 32 and B1 through B6 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, discuss the information system, including related business processes, relevant to financial reporting."

f. In paragraph .15, the reference to section 319 is replaced with a reference to Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

g. The last sentence of paragraph .35 is replaced with:

In addition, paragraphs 24 through 27 of Auditing Standard No. 14, Evaluating Audit Results, describe the auditor's responsibilities for assessing bias in accounting estimates.

h. In paragraph .43, subparagraph a., the word "competent" is replaced with the word "appropriate."

i. In paragraph .51, the last sentence is replaced with:

(See paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results.)

j. In paragraph .57, subparagraph c., the word "competent" is replaced with the word "appropriate."

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows:

a. Footnote 4 to paragraph .06 is replaced with:

Auditing Standard No. 14, Evaluating Audit Results, indicates that a misstatement can arise from error or fraud and also discusses the auditor's responsibilities for evaluating accumulated misstatements.

b. Within footnote 6 to paragraph .06, the reference to Section 312 is replaced with a reference to Paragraph 11 of Auditing Standard No. 14, Evaluating Audit Results.

c. Within footnote 7 to paragraph .06, the reference to section 316, Consideration of Fraud in a Financial Statement Audit, paragraphs .38 through .40, is replaced with a reference to section 316, Consideration of Fraud in a Financial Statement Audit, paragraphs .79 through .82.

AU sec. 334, "Related Parties"

SAS No. 45, "Related Parties" (AU sec. 334 "Related Parties"), is amended as follows:

a. In the second sentence of paragraph .09, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

c. In footnote 8 to paragraph .11, the reference to section 431, Adequacy of Disclosure in Financial Statements, is replaced with a reference to paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results.

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334"

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334," is amended as follows:

Within footnote 4 to paragraph .17, the reference to section 312, Audit Risk and Materiality in Conducting an Audit, is replaced with a reference to Auditing Standard No. 8, Audit Risk.

AU sec. 336, "Using the Work of a Specialist"

SAS No. 73, "Using the Work of a Specialist" (AU sec. 336, "Using the Work of a Specialist"), is amended as follows:

a. Footnote 1 to paragraph .01 is replaced with the following:

   Because income taxes and information technology are specialized areas of accounting and auditing, this section does not apply to situations in which an income tax specialist or information technology specialist participates in the audit. Auditing Standard No. 10, Supervision of the Audit Engagement, applies in those situations.

b. Paragraph .05 is replaced with the following:

   This section does not apply to situations in which a specialist employed by the auditor's firm participates in the audit. Auditing Standard No. 10, Supervision of the Audit Engagement, applies in those situations.

c. In the last sentence of paragraph .06, the word "competent" is replaced with the word "appropriate."

d. In the first and last sentences of paragraph .13, the word "competent" is replaced with the word "appropriate."

AU sec. 9336, "Using the Work of a Specialist: Auditing Interpretations of Section 336"

AU sec. 9336, "Using the Work of a Specialist: Auditing Interpretations of Section 336," is amended as follows:

a. In the second sentence of paragraph .04, the word "competent" is replaced with the word "appropriate."

b. In paragraph .05, the word "competent" is replaced with the word "appropriate."

c. In the second sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

d. The penultimate sentence of paragraph .15, is replaced with:

Paragraph 6 of Auditing Standard No. 15, Audit Evidence, states, "[t]o be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based."

AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"

SAS No. 59, "The Auditor's Consideration of an Entity's Ability to Continue as Going Concern" (AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"), as amended, is amended as follows:

The reference in paragraph .02 to section 326, Evidential Matter, is replaced with a reference to Auditing Standard No. 15, Audit Evidence.

AU sec. 342, "Auditing Accounting Estimates"

SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), as amended, is amended as follows:

a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .07, the word "competent" is replaced with the word "appropriate."

c. The text of footnote 3 to paragraph .07 is replaced with:

   See paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results.

d. The reference in paragraph .08 subparagraph b.1. to section 311, Planning and Supervision, is replaced with a reference to Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

e. Paragraph .14, is replaced with:

Paragraphs 24 through 27 of Auditing Standard No. 14, Evaluating Audit Results, discuss the auditor's responsibilities for assessing bias and evaluating accounting estimates in relationship to the financial statements taken as a whole.

AU sec. 9342, "Auditing Accounting Estimates: Auditing Interpretations of Section 342"

AU sec. 9342, "Auditing Accounting Estimates: Auditing Interpretations of Section 342," is amended as follows:

In the second sentence of paragraph .02, the word "competent" is replaced with the word "appropriate."

AU sec. 350, "Audit Sampling"

SAS No. 39, "Audit Sampling" (AU sec. 350, "Audit Sampling"), as amended, is amended as follows:

a. Within footnote 2 to paragraph .02, the reference to section 312, Audit Risk and Materiality in Conducting an Audit, is replaced with a reference to Auditing Standard No. 14, Evaluating Audit Results.

b. The last sentence of paragraph .03 is replaced with:

Either approach to audit sampling can provide sufficient evidential matter when applied properly. This section applies to both nonstatistical and statistical sampling.

c. Paragraph .04 is deleted.

d. In paragraph .06:

- The first sentence is deleted.
- In the last sentence, the word "competence" is replaced with the word "appropriateness."
- The following note is added to the paragraph:

  Note: Auditing Standard No. 15, Audit Evidence, discusses the appropriateness of audit evidence, and Auditing Standard No. 14, Evaluating Audit Results, discusses the auditor's responsibilities for evaluating the sufficiency and appropriateness of audit evidence.

e. Paragraph .08 is deleted.

f. In paragraph .09:

- The sentence in paragraph .09 referring to section 313, which is in parentheses, is deleted.

- The following note is added to the paragraph:

  Note: Auditing Standard No. 8, Audit Risk, describes audit risk and its components in a financial statement audit – the risk of material misstatement (consisting of inherent risk and control risk) and detection risk.

g. In paragraph .11:

- The phrase "(see section 311, Planning and Supervision)" is deleted.

- The sentence "(See section 313.)" is deleted.

h. The second sentence of paragraph .15 is replaced with:

See Auditing Standard No. 9, Audit Planning.

i. In the first bullet in paragraph .16, the phrase "(see section 326, Evidential Matter)" is deleted.

j. In the second bullet of paragraph .16, the phrase "Preliminary judgments about materiality levels" is replaced with the phrase "Tolerable misstatement. (See paragraphs .18-.18A.)"

k. Paragraph .18 is replaced with:

Evaluation in monetary terms of the results of a sample for a substantive test of details contributes directly to the auditor's purpose, since such an evaluation can be related to his or her judgment of the monetary amount of misstatements that would be material. When planning a sample for a substantive test of details, the auditor should consider how much monetary misstatement in the related account balance or class of transactions may exist, in combination with other misstatements, without causing the financial statements to be materially misstated. This maximum monetary misstatement for the account balance or class of transactions is called tolerable misstatement.

l. Paragraph .18A is added:

Paragraphs 8 - 9 of Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit, describe the auditor's responsibilities for determining tolerable misstatement at the account or disclosure level. When the population to be sampled constitutes a portion of an account balance or transaction class, the auditor should determine tolerable misstatement for the population to be sampled for purposes of designing the sampling plan. Tolerable misstatement for the population to be sampled ordinarily should be less than tolerable misstatement for the account balance or transaction class to allow for the possibility that misstatement in the portion of the account or transaction class not subject to audit sampling, individually or in combination with other misstatements, would cause the financial statements to be materially misstated.

m. Paragraph .20 is deleted.

n. The first sentence of paragraph .21 is replaced with the following sentence:

The sufficiency of tests of details for a particular account balance or class of transactions is related to the individual importance of the items examined as well as to the potential for material misstatement.

o. Paragraph .23 is replaced with:

To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account tolerable misstatement for the population; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements.

p. Paragraph .23A is added:

Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

q. The last sentence of paragraph .25 is replaced with:

The auditor also should evaluate whether the reasons for his or her inability to examine the items have (a) implications in relation to his or her risk assessments (including the assessment of fraud risk), (b) implications regarding the integrity of management or employees, and (c) possible effects on other aspects of the audit.

r. Footnote 6 to paragraph .26 is replaced with:

Paragraphs 10 through 23 of Auditing Standard No. 14, Evaluating Audit Results, discuss the auditor's consideration of differences between the accounting records and the underlying facts and circumstances.

s. Within footnote 7 to paragraph .32, the phrase "(see section 319.85)" is deleted. In the first sentence of the footnote, the phrase "often plans" is replaced with the phrase "may plan." The last sentence of the footnote, which is in brackets, is deleted.

t. The last sentence of paragraph .38 is replaced with:

When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

u. The fifth sentence of paragraph .39 is replaced with:

Paragraphs 44 through 46 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, describe the auditor's responsibilities for performing procedures between the interim date of testing and period end.

v. In paragraph .39, the last sentence, which is in brackets, is deleted.

w. In paragraph .44:

- The first sentence is replaced with:

  In some circumstances, the auditor may design a sample that will be used for dual purposes: as a test of control and as a substantive test.

- The third sentence is replaced with:

  For example, an auditor designing a test of a control over entries in the voucher register may design a related substantive test at a risk level that is based on an expectation of reliance on the control.

- The fifth sentence is replaced with:

  In evaluating such tests, deviations from the control that was tested and monetary misstatements should be evaluated separately using the risk levels applicable for the respective purposes.

- The following Note is added to the paragraph:

  Note: Paragraph 47 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, provides additional discussion of the auditor's responsibilities for performing dual-purpose tests.

x. The reference in paragraph .45 to paragraph .04 is changed to a reference to paragraph .03.

y. In item 2 of paragraph .48, the last sentence is deleted.

z. Within footnote 1 to item 4 in paragraph .48, the sentence "(See section 313.)" is deleted.

aa. The sentence in item 6 of paragraph .48 "(See section 313.)" is deleted.

AU sec. 9350, "Audit Sampling: Auditing Interpretations of Section 350"

AU sec. 9350, "Audit Sampling: Auditing Interpretations of Section 350," is superseded.

AU sec. 380, "Communication With Audit Committees"

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees"), as amended, is amended as follows:

In footnote 5 to paragraph .10, the reference to section 316A.38 -.40 is replaced with a reference to AU secs. 316.79 -.82; the reference to section 316A is replaced with a reference to section 316.

AU sec. 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles"

SAS No. 69, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles" (AU sec. 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles"), as amended, is amended as follows:

a. In paragraph .04, the reference in (c) to section 431 is replaced with a reference to paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results; in (d), the reference to section 431 is replaced with a reference to paragraph 31 of Auditing Standard No. 14.

b. The reference in footnote 1 to paragraph .04 to 312.10 is replaced with a reference to Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit.

AU sec. 431, "Adequacy of Disclosure in Financial Statements"

SAS No. 32, "Adequacy of Disclosure in Financial Statements" (AU sec. 431, "Adequacy of Disclosure in Financial Statements"), as amended, is superseded.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements" (AU sec. 508, "Reports on Audited Financial Statements"), as amended, is amended as follows:

a. In paragraph 18C, the phrase "and in AU sec. 431" is deleted.

b. In subparagraph .20.a., the word "competent" is replaced with the word "appropriate."

c. In the second sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."

d. In the third sentence of paragraph .24, the word "competent" is replaced with the word "appropriate."

e. In footnote 15 to paragraph .38, the first sentence is replaced with:

In this context, practicable means that the information is reasonably obtainable from management's accounts and records and that providing the information in the report does not require the auditor to assume the position of a preparer of financial information.

f. The references in paragraph .49 to section 312, Audit Risk and Materiality, and to section 342, Auditing Accounting Estimates, are replaced with a reference to paragraph 13 of Auditing Standard No. 14, Evaluating Audit Results.

g. In the first sentence of paragraph .63, the word "competent" is replaced with the word "appropriate."

h. In paragraph .66, the second sentence is replaced with:

(See paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results.)

AU sec. 9508, "Reports on Audited Financial Statements: Auditing Interpretations of Section 508"

AU sec. 9508, "Reports on Audited Financial Statements: Auditing Interpretations of Section 508," is amended as follows:

In paragraph .02, the word "competent" is replaced with the word "appropriate."

AU sec. 530, "Dating of the Independent Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 530, "Dating of the Independent Auditor's Report" (AU sec. 530, "Dating of the Independent Auditor's Report"), as amended, is amended as follows:

a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."

b. In the second note to paragraph .01, the word "competent" is replaced with the word "appropriate."

c. In the first sentence of paragraph .05, the word "competent" is replaced with the word "appropriate."

AU sec. 543, "Part of Audit Performed by Other Independent Auditors"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 543 "Part of Audit Performed by Other Independent Auditors" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), as amended, is amended as follows:

a. The following note is added as the second note to paragraph .01:

Note: For situations in which the auditor engages an accounting firm or individual accountants to participate in the audit engagement and AU sec. 543 does not apply, the auditor should supervise them in accordance with the requirements of Auditing Standard No. 10, Supervision of the Audit Engagement.

b. Within paragraph .12:

- Subparagraph b. is replaced with:

  A list of significant risks, the auditor's responses, and the results of the auditor's related procedures.

- Subparagraph f. is replaced with:

  A schedule of accumulated misstatements, including a description of the nature and cause of each accumulated misstatement, and an evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543"

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543," as amended, is amended as follows:

a. Paragraph .16 is replaced with:

Interpretation − The principal auditor's response should ordinarily be made by the engagement partner. The engagement partner should take those steps that he or she considers reasonable under the circumstances to be informed of known matters pertinent to the other auditor's inquiry. For example, the engagement partner may inquire of engagement team members responsible for various aspects of the engagement or he or she may direct engagement team members to bring to his or her attention any significant matters of which they become aware during the audit. The principal auditor is not required to perform any procedures directed toward identifying matters that would not affect his or her audit or his or her report.

b. Footnote 4 to paragraph .16 is deleted.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

a. Within footnote 7 to paragraph .11, the first sentence is replaced with:

Paragraphs 10 through 23 of Auditing Standard No. 14, Evaluating Audit Results, require the auditor to accumulate and evaluate the misstatements identified during the audit.

b. The reference in paragraph .13 to section 319, Consideration of Internal Control in a Financial Statement Audit, is replaced with a reference to Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

c. Within the last sentence of paragraph .16, the title of section 329, "Analytical Procedures," is replaced with the title "Substantive Analytical Procedures."

d. Footnote 20 to paragraph .26 is deleted.

e. The reference in paragraph .56, subparagraph C5, to section 319 is replaced with a reference to section 316.

Auditing Standard No. 3, Audit Documentation

Auditing Standard No. 3, Audit Documentation, as amended, is amended as follows:

a. Within paragraph 3, subparagraph b. is replaced with:

Supervisory personnel who review documentation prepared by other members of the engagement team.

b. Paragraph 9A is added:

Documentation of risk assessment procedures and responses to risks of misstatement should include (1) a summary of the identified risks of misstatement and the auditor's assessment of risks of material misstatement at the financial statement and assertion levels and (2) the auditor's responses to the risks of material misstatement, including linkage of the responses to those risks.

c. Within paragraph 12:

- Within subparagraph a.:, (1) a footnote reference 2A is added at the end of the first sentence:

  See paragraphs 12-13 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, and paragraphs .66-.67 of AU sec. 316, Consideration of Fraud in a Financial Statement Audit.

  and (2) the second sentence of subparagraph a. is deleted.

- Subparagraph b. is replaced with:

  Results of auditing procedures that indicate a need for significant modification of planned auditing procedures, the existence of material misstatements (including omissions in the financial statements), and the existence of significant deficiencies or material weaknesses in internal control over financial reporting.

- Subparagraph c. is replaced with:

  Accumulated misstatements and evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

- Footnote 2B is added to subparagraph c.:

  See paragraphs 10-23 of Auditing Standard No. 14, Evaluating Audit Results.

- Subparagraph d. is replaced with:

  Disagreements among members of the engagement team or with others consulted on the engagement about final conclusions reached on significant accounting or auditing matters, including the basis for the final resolution of those disagreements. If an engagement team member disagrees with the final conclusions reached, he or she should document that disagreement.

- Subparagraph f. is replaced with:

Significant changes in the auditor's risk assessments, including risks that were not identified previously, and the modifications to audit procedures or additional audit procedures performed in response to those changes.

- Footnote 2C is added to subparagraph f.:

See paragraph 74 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, and paragraph 36 of Auditing Standard No. 14, Evaluating Audit Results.

- Subparagraph f-1. is added:

Risks of material misstatement that are determined to be significant risks and the results of the auditing procedures performed in response to those risks.

d. Within paragraph 19:

- Subparagraph b. is replaced with:

A list of significant risks, the auditor's responses, and the results of the auditor's related procedures.

- Subparagraph f. is replaced with:

A schedule of accumulated misstatements, including a description of the nature and cause of each accumulated misstatement, and an evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

e. Paragraph 21 and the preceding heading, "Effective Date," are deleted.

Auditing Standard No. 4, Reporting on Whether a Previously Reported Material Weakness Continues to Exist

Auditing Standard No. 4, Reporting on Whether a Previously Reported Material Weakness Continues to Exist, as amended, is amended as follows:

In the first sentence of paragraph 18, the word "competent" is replaced with the word "appropriate."

Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, is amended as follows:

a. In the second sentence of paragraph 3, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph 9, the phrase "any assistants" is replaced with the phrase "the engagement team members."

c. Within footnote 10 to paragraph 14, the reference to paragraphs .19-.42 of AU sec. 316, Consideration of Fraud in a Financial Statement Audit, is replaced with a reference to Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

d. The reference in paragraph 15 to AU sec. 316.44 and .45 is replaced with a reference to paragraphs 65-69 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

e. Within footnote 11 to paragraph 20, the reference to AU sec. 312, Audit Risk and Materiality in Conducting an Audit, is replaced with a reference to Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit.

f. Within footnote 12 to paragraph 28, the reference to AU sec. 326, Evidential Matter, is replaced with a reference to Auditing Standard No. 15, Audit Evidence.

g. Within footnote 13 to the note to paragraph 31, the reference to AU sec. 312.39 is replaced with a reference to paragraph 14 of Auditing Standard No. 14, Evaluating Auditing Results. The reference to AU sec. 316.50 is replaced with a reference to paragraph 5 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

h. The references in paragraph 36 to paragraphs .16-.20, .30-.32, and .77-.79 of AU sec. 319, Consideration of Internal Control in a Financial Statement Audit, are replaced with references to paragraph 29 and Appendix B of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

i. In the first sentence of paragraph 51, the word "competent" is replaced with the word "appropriate."

j. In the first sentence of paragraph 89, the word "competent" is replaced with the word "appropriate."

k. Within the note to paragraph C6 in Appendix C, the word "competent" is replaced with the word "appropriate."

Auditing Standard No. 6, Evaluating Consistency of Financial Statements

Auditing Standard No. 6, Evaluating Consistency of Financial Statements, is amended as follows:

a. Footnote 3 to paragraph 4 is deleted.

b. In paragraph 10, the reference to AU sec. 431, Adequacy of Disclosure in Financial Statements, is replaced with a reference to paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results.

Auditing Standard No. 7, Engagement Quality Review

Auditing Standard No. 7, Engagement Quality Review, is amended as follows:

a. Footnote 3 to paragraph 5 is replaced with:

> The term "engagement partner" has the same meaning as the "practitioner-in-charge of an engagement" in PCAOB interim quality control standard QC sec. 40, The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement. QC sec. 40 describes the competencies required of a practitioner-in-charge of an attest engagement.

b. In paragraph 10, the note following subparagraph b. is replaced with:

> Note: A significant risk is a risk of material misstatement that requires special audit consideration.

Ethics Standards

ET sec. 102, "Integrity and Objectivity"

ET sec. 102, "Integrity and Objectivity," is amended as follows:

Footnote 1 to paragraph .05 is replaced with:

See paragraph 5.b. of Auditing Standard No. 10, Supervision of the Audit Engagement, and paragraph 12.d. of Auditing Standard No. 3, Audit Documentation.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rules and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

(a) Purpose

Section 103(a) of the Act directs the Board, by rule, to establish, among other things, "auditing and related attestation standards . . . to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by th[e] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." As discussed more fully in Exhibit 3, the Board adopted eight auditing standards and related amendments that benefit investors by establishing requirements that enhance the effectiveness of the auditor's assessment of and response to the risks of material misstatement in an audit.

In an audit performed in accordance with PCAOB standards, risk underlies the entire audit process, including the procedures that the auditor performs to support the opinion expressed in the auditor's report. Most of the Board's interim auditing standards relating to assessing and responding to risk in an audit of financial statements were developed in the 1980s.[154/] Those standards described in general terms the auditor's responsibilities for assessing and responding to risk. They directed auditors to vary the amount of audit attention related to particular financial statement accounts based on the risks presented by them. The standards also allowed the auditor to use tests of controls to reduce substantive testing.[155/]

A number of factors and events led the Board to reexamine those standards and seek to improve them. These included the widespread use of risk-based audit methodologies; recommendations to the profession on ways in which auditors could improve risk assessment;[156/] advice from the Board's Standing Advisory Group ("SAG");[157/] adoption of Auditing Standard No. 5, An Audit of Internal Control Over

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154/ Examples of those standards include AU sec. 312, Audit Risk and Materiality in Conducting an Audit, and AU sec. 319, Consideration of Internal Control in a Financial Statement Audit.

155/ AU sec. 319.

156/ See, e.g., Public Oversight Board, Panel on Audit Effectiveness ("PAE"), Report and Recommendations (August 31, 2000). For a summary of the PAE's recommendations related to risk assessment, see PCAOB Standing Advisory Group ("SAG") Meeting Briefing Paper, "Risk Assessment in Financial Statement Audits" (February 16, 2005), Appendix A, available at: http://www.pcaobus.org/News_and_Events/Events/2005/02-16.aspx.

157/ Webcasts of SAG meetings are available on the Board's Web site at: http://www.pcaobus.org/News_and_Events/Webcasts.

Financial Reporting That Is Integrated with An Audit of Financial Statements; and observations from the Board's oversight activities.

On October 21, 2008, the Board proposed a set of auditing standards to update the requirements for assessing and responding to risk in an audit ("the original proposed standards").[158/] The original proposed standards were intended to improve the auditing standards and to benefit investors by establishing requirements that enhance the effectiveness of auditors' assessment of and response to risk through:

- Performing procedures that provide a reasonable basis for identifying and assessing risks of material misstatement, whether due to error or fraud

- Tailoring the audit to respond appropriately to the risks of material misstatement

- Making a comprehensive evaluation of the evidence obtained during the audit to form the opinion(s) in the auditor's report

The Board also sought to emphasize the auditor's responsibilities for consideration of fraud by incorporating requirements for identifying and responding to the risks of material misstatement due to fraud ("fraud risks") and evaluating audit results from the existing PCAOB standard, AU sec. 316, Consideration of Fraud in a Financial

[158/] PCAOB Release No. 2008-006, Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk (October 21, 2008).

Statement Audit.[159] Incorporating these requirements makes clear that the auditor's responsibilities for assessing and responding to fraud risks are an integral part of the audit process rather than a separate, parallel process. It also benefits investors by prompting auditors to make a more thoughtful and thorough assessment of fraud risks and to develop appropriate audit responses.

Improvements in the standards related to risk assessment also should enhance integration of the audit of financial statements with the audit of internal control over financial reporting ("audit of internal control") by articulating a process for identifying and assessing risks of material misstatement that applies to both portions of the integrated audit when the auditor is performing an integrated audit.

The proposed rules also amend the Board's interim standards including superseding the following sections of PCAOB interim auditing standards:

- AU sec. 311, Planning and Supervision
- AU sec. 312, Audit Risk and Materiality in Conducting an Audit
- AU sec. 313, Substantive Tests Prior to the Balance Sheet Date
- AU sec. 319, Consideration of Internal Control in a Financial Statement Audit

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[159] Paragraphs .14-.51 and paragraphs .68-.78 of AU sec. 316, Consideration of Fraud in a Financial Statement Audit.

- AU sec. 326, Evidential Matter
- AU sec. 431, Adequacy of Disclosure in Financial Statements

Similarly, the auditing interpretations of AU secs. 311, 312, and 350 have been incorporated into the risk assessment standards and thus are superseded. The auditing interpretations of AU sec. 326, except for Interpretation No. 2 (AU secs. 9326.06-.23), also are superseded.[160/]

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

B. Board's Statement on Burden on Competition

The Board does not believe that the proposed rule changes will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rule changes would apply equally to all registered public accounting firms conducting audits in accordance with PCAOB standards.

C. Board's Statement on Comments on the Proposed Rules Received from Members, Participants or Others

The Board released the proposed rules for public comment in PCAOB Release No. 2008-006 (October 21, 2008). The Board received 33 written comments. The Board considered these comments and made changes to the initial proposed rules. As a result,

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[160/] Interpretation No. 2 relates in part to AU sec. 336 and AU sec. 337, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments, and it will be evaluated in connection with standards-setting projects related to those standards.

the Board again sought public comment in PCOAB Release No. 2009-007 (December 21, 2009). The Board received 23 written comment letters relating to its reproposal of the proposed rules. A copy of PCAOB Release Nos. 2008-006 and 2009-007 and the comment letters received in response to the PCAOB's request for comment in both releases are available on the PCAOB's web site at www.pcaobus.org.

The Board has carefully considered all comments it has received. In response to the written comments received on both the initial and reproposal of the proposed rules, the Board has clarified and modified certain aspects of the proposed rules, as discussed below.

Overview of the Risk Assessment Standards

Many commenters on the original proposed standards were supportive of the Board's efforts to update its risk assessment requirements and offered numerous suggestions for changing the original proposed standards. After considering all of the comments received on those standards, the Board made numerous refinements to the original proposed standards. Because the standards address many fundamental aspects of the audit process and are expected to serve as a foundation for future standards-setting, the Board reproposed the standards for public comment on December 17, 2009 ("the reproposed standards").[161/]

[161/] PCAOB Release No. 2009-007, Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk (December 17, 2009).

The Board received 23 comment letters on the reproposed standards.[162/] The Board discussed the comments received with the SAG on April 8, 2010.[163/] Most commenters were generally supportive of the reproposed standards and the improvements made to those standards. Many commenters also offered suggestions to improve the standards, which the Board has carefully analyzed.

After consideration of the comments received, the Board has refined the standards to provide additional clarity. The Board has decided to adopt the following standards for assessing and responding to risk in an audit and the related amendments to PCAOB standards:

- Auditing Standard No. 8, Audit Risk
- Auditing Standard No. 9, Audit Planning
- Auditing Standard No. 10, Supervision of the Audit Engagement
- Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit

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162/ Comments on the original proposed standards and the reproposed standards are available on the Board's Web site at: http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx.

163/ A transcript of the portion of the meeting that related to the reproposed standards is available on the Board's Web site at: http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx.

- Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement
- Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement
- Auditing Standard No. 14, Evaluating Audit Results
- Auditing Standard No. 15, Audit Evidence

1. Notable Areas of Change in the Standards

The changes made to the reproposed standards reflect refinements rather than significant shifts in approach. This section describes the areas of change to the reproposed standards that are most notable, e.g., because they affect multiple standards or multiple sections of an individual standard. This Release discusses these and other changes in more detail.

a. Planning and Supervision Standards

The reproposed standards included a standard covering both audit planning and supervision. Some commenters observed that audit planning and supervision should be covered in separate standards.

Audit planning and supervision, although related in some respects, are distinct activities that should be presented in separate standards. Accordingly, the Board has divided the planning and supervision standard into separate standards for planning and for supervision. Presenting the requirements for planning and supervision in separate standards is a technical change that, by itself, does not affect the auditor's responsibilities for planning the audit or supervision of the work of engagement team members as described in the reproposed standards.

b. Requirements for Multi-location Audits

The reproposed standard on audit planning and supervision included requirements regarding establishing the scope of testing of individual locations in multi-location engagements. The reproposed standard on consideration of materiality in planning and performing an audit included requirements for determining materiality of individual locations in multi-location audits. Some commenters requested clarification on the Board's expectations regarding how to apply those requirements in audits in which part of the work is performed by other auditors, specifically, auditors of financial statements of individual locations or business units that are included in the consolidated financial statements.

The multi-location requirements have been revised to take into account situations in which part of the work is performed by other auditors.[164/] This release discusses those

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[164/] Paragraphs 11-14 of Auditing Standard No. 9, Audit Planning, and paragraph 10 of Auditing Standard No. 11, Consideration of Materiality in Planning and Performing an Audit.

revisions in more detail and explains the Board's expectations regarding how to apply the respective requirements in situations involving other auditors.

The reproposed standard on audit planning and supervision also included a statement, similar to a statement in Auditing Standard No. 5, that "The direction in paragraph 5 of Proposed Auditing Standard, The Auditor's Responses to the Risks of Material Misstatement, regarding incorporating an element of unpredictability in the auditing procedures means that the auditor should vary the nature, timing, and extent of audit procedures at locations or business units from year to year." Some commenters stated that the statement in the reproposed audit planning and supervision standard was unnecessarily prescriptive. After considering the comments received, the requirement regarding unpredictability was removed from the audit planning standard, and the discussion in Auditing Standard No. 13 regarding incorporating an element of unpredictability was expanded to include varying the testing in the selected locations.[165/] However, this does not change the requirements in Auditing Standard No. 5 regarding incorporating unpredictability in testing controls at individual locations in audits of internal control.[166/]

165/ Paragraph 5 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

166/ Paragraphs 61 and B13 of Auditing Standard No. 5.

c. Requirement for Performing Walkthroughs

In the original proposed standards, the standard on identifying and assessing risks of material misstatement referred auditors to Auditing Standard No. 5 for a discussion of the performance of walkthroughs. Some commenters on the original proposed standards stated that the proposed standard should include a discussion of walkthroughs rather than referring to Auditing Standard No. 5. The reproposed standard on identifying and assessing risks of material misstatement included a discussion of the objectives for understanding likely sources of potential misstatements and of performing walkthroughs, which paralleled a discussion in Auditing Standard No. 5.[167/] Some commenters expressed concerns that those new requirements would lead to unnecessary walkthroughs, particularly in audits of financial statements only.

The intention of including the discussion of walkthroughs was to describe how to perform walkthroughs, not to impose additional requirements regarding when to perform walkthroughs. The discussion has been revised to focus on how the auditor should perform walkthroughs, and the discussion of the objectives for understanding likely sources of potential misstatements has been removed.[168/] Consequently, the objectives in paragraph 34 of Auditing Standard No. 5 for understanding potential sources of likely misstatement will continue to apply only to integrated audits.

[167/] Paragraph 34 of Auditing Standard No. 5.

[168/] Paragraphs 37-38 of Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

d. Requirements Regarding Financial Statement Disclosures

Because of the importance of disclosures to the fair presentation of financial statements and based on observations from the Board's oversight activities, the reproposed standards included additional requirements intended to increase the auditor's attention on the disclosures in the financial statements. For example, the reproposed standard on identifying and assessing risks of material misstatement included a new requirement related to developing an expectation about the necessary financial statement disclosures as part of obtaining an understanding of the company and its environment. Some commenters stated that the requirements should be clarified as applying to disclosures required by the applicable financial reporting framework. Also, the reproposed standard on evaluating audit results included expanded requirements for the auditor to evaluate whether the financial statements include the required disclosures. Some commenters stated that the standard should clarify that the requirements apply only to material disclosures.

After analyzing the comments, those two requirements have been revised to clarify that they refer to the fair presentation of the financial statements in conformity with the applicable financial reporting framework.[169/]

[169/] Paragraph 13 of Auditing Standard No. 12 and paragraph 31 of Auditing Standard No. 14, Evaluating Audit Results.

2. Discussion of Comments That Relate to Many of the Reproposed Standards

The following paragraphs discuss matters raised by commenters that relate to many of the reproposed standards. Section II.C.13 of this release contains a discussion of other topics raised by commenters on matters other than the risk assessment standards or the related amendments.

a. Consideration of Fraud in the Audit

Section I of the Board's adopting release discusses the Board's objectives regarding incorporating into its risk assessment standards the requirements for identifying and responding to risks of material misstatement due to fraud ("fraud risks") and evaluating audit results from AU sec. 316, Consideration of Fraud in a Financial Statement Audit.[170/]

The number of comments received on this approach to incorporate the requirements from AU sec. 316 declined significantly from the original proposed standards.[171/] The views of commenters continue to be mixed. One commenter supported the approach, and two commenters expressed concerns about the approach.

[170/] The risk assessment standards incorporate paragraphs .14-.51 and .68-.78 of AU sec. 316. Accordingly, those paragraphs are removed from AU sec. 316 by means of a related amendment.

[171/] As discussed in Section I, the risk assessment standards were originally proposed on October 21, 2008. See PCAOB Release No. 2008-006, Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk.

The risk assessment standards continue to include relevant requirements from AU sec. 316. The Board has observed from its oversight activities instances in which auditors have performed the procedures required in AU sec. 316 mechanically, without using the procedures to develop insights on fraud risk or to modify the audit plan to address that risk. The Board also has observed instances in which firms have failed to respond appropriately to identified fraud risks.

These observations suggest that some auditors may improperly view the consideration of fraud as an isolated, mechanical process rather than an integral part of audits under PCAOB standards. Integrating the requirements from AU sec. 316 into the risk assessment standards emphasizes to auditors that assessing and responding to fraud risks is an integral part of an audit in accordance with PCAOB standards, rather than a separate consideration. Such integration also should prompt auditors to make a more thoughtful and thorough assessment of the risks affecting the financial statements, including fraud risks, and to develop appropriate audit responses. Furthermore, AU sec. 316, as amended, will continue to provide relevant information on determining the necessary procedures for considering fraud in a financial statement audit. (See section II.C.11.F.(ii). of this release for more discussion about AU sec. 316.)

b. Organization and Style of Standards (Including the Use of Notes and Appendices)

In response to comments on the original proposed standards, the Board presented the reproposed standards using an organization and style that is intended to be a template for future standards of the Board. The organization and style includes an objective for each standard, which provides additional context for understanding the requirements in the standard, and a separate appendix for definitions of terms used in each standard.

Commenters generally supported the organization and style of the reproposed standards, and some commenters suggested that existing PCAOB standards be revised to implement this organization and style. As stated in the release accompanying the reproposed standards, the organization and style used in the reproposed standards draws from previously issued standards of the Board, e.g., Auditing Standard No. 7, Engagement Quality Review. Also, the Board will apply this template in the course of its other standards-setting activities.

Commenters expressed concerns about including requirements in appendices and notes to the standard. Consistent with standards previously issued by the Board, the notes and appendices in the risk assessment standards are integral parts of the standards and carry the same authoritative weight as the other portions of the standards.

c. Use of Terms

PCAOB Rule 3101, Certain Terms Used in Auditing and Related Professional Practice Standards, sets forth the terminology that the Board uses to describe the degree of responsibility that the auditing and related professional practice standards impose on auditors. The original proposed standards used terms in the requirements in a manner that was consistent with Rule 3101.

Some comments received on the original proposed standards suggested revisions to the terms used in the requirements or asked for clarification about certain terms or phrases, e.g., "take into account." The reproposed standards reflected numerous revisions to the terms used in the standards, and the risk assessment standards reflect further refinements. For example, the standards use "should consider" only when referring to a requirement to consider performing an action or procedure, which is consistent with Rule 3101.

As explained in the release accompanying the reproposed standards, the phrase "take into account" has been used previously in PCAOB standards in reference to information or matters that the auditor should think about or give attention to in performing an audit procedure or reaching a conclusion.[172/] Accordingly, the results of the auditor's thinking on the relevant matters should be reflected in the performance and

[172/] AU sec. 316.45 and paragraphs 14, 44, 59, and B 12 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

documentation of the respective audit procedure performed or conclusion reached. The accompanying standards continue to use "take into account" in the same way.

Some commenters asked about the meaning of certain terms, e.g., "assess," "evaluate," or "determine." Those commenters also stated that the Board should use those terms consistently throughout its standards. The Board has reviewed the use of each of those terms and has revised the standards as necessary to apply those terms more consistently. Subsequent sections of this release discuss specific revisions to the individual standards.

One commenter expressed concerns about statements that involve the use of present tense in the reproposed standards. As with standards that the Board previously issued, the present tense is used in the risk assessment standards for statements that are factual or definitional, e.g., to provide additional explanation of a required auditing procedure.[173/] Subsequent sections of this release discuss specific instances of the use of present tense in the risk assessment standards.

d. Requirements and the Application of Judgment

Some commenters on the original proposed standards stated that the original proposed standards contained requirements that were "too prescriptive," limiting the auditor's ability to "use professional judgment or scale the audit," e.g., because of the

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[173/] See, e.g., paragraph 21 of Auditing Standard No. 5 for an example of the use of the present tense for this purpose.

number of requirements in the standards and because the standards did not explicitly refer to professional judgment in the requirements. In the release accompanying the reproposed standards, the Board discussed the importance of professional judgment in fulfilling the requirements of the standards. After examining each requirement, the Board revised certain provisions in the reproposed standards to streamline the presentation of those requirements.

Although the Board received fewer comments on the reproposed standard related to this topic, two commenters continue to express concerns about whether the reproposed standards made adequate allowance for the auditor to use professional judgment in assessing and responding to risk in an audit.

PCAOB standards recognize that the auditor uses judgment in planning and performing audit procedures and evaluating the evidence obtained from those procedures.[174/] As under other PCAOB standards, auditors need to exercise judgment in fulfilling the requirements of the risk assessment standards in the particular circumstances. Making references to judgment in selected portions of the standards, however, could be misinterpreted as indicating that judgment is required only in certain aspects of the audit. Instead of referring to judgment selectively, the risk assessment standards set forth principles for meeting the requirements of the standards and allow the

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[174/] See, e.g., paragraph .11 of AU sec. 230, Due Professional Care in the Performance of Work.

auditor to determine the most appropriate way to comply with the requirements in the circumstances.

3. Auditing Standard No. 8 – Audit Risk

a. Background

Auditing Standard No. 8 discusses audit risk and the relationships among the various components of audit risk in an audit of financial statements. The standard applies to integrated audits and to audits of financial statements only.

b. Objective

The reproposed standard stated that the objective of the auditor is to conduct the audit of financial statements in a manner that reduces audit risk to an appropriately low level. This objective provided important context for understanding how the concept of audit risk is applied in an audit.

One commenter observed that the reproposed standards sometimes used the phrase, "appropriately low level" and occasionally used the phrase "acceptably low level," and that commenter suggested revising the standards to use "acceptably low level" in each instance. The Board continues to believe the term "appropriately low level" is more suitable because it is aligned more closely with the degree of assurance described in the auditor's opinion, i.e., the auditor conducts the audit to reduce audit risk to an appropriately low level in order to express an opinion with reasonable assurance. In contrast, the term "acceptably low" is less clear and could be misinterpreted. The risk assessment standards have been revised to use the phrase "appropriately low level," as applicable.

c. Due Professional Care and Sufficient Appropriate Audit Evidence

The reproposed standard stated that, to form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. It also stated that reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.[175/]

A commenter suggested that due professional care is a responsibility throughout the audit, similar to professional skepticism and judgment, and need not be repeated throughout the Board's standards. The Board agrees that due professional care is a responsibility throughout the audit. On the other hand, existing PCAOB standards state that due professional care allows the auditor to obtain reasonable assurance,[176/] and the statement in Auditing Standard No. 8 acknowledges that principle.

[175/] Paragraph 3 of Auditing Standard No. 8.

[176/] AU sec. 230.10.

d. Audit Risk and Risk of Material Misstatement

Some commenters on the original proposed standard requested more explanation about risks at the overall financial statement level, e.g., by providing examples of such risks. The reproposed standard elaborated further on risks at the financial statement level.[177/]

Commenters on the reproposed standard asked for more explanation regarding how financial statement level risks can result in material misstatement of the financial statements. The examples of financial statement level risks in Auditing Standard No. 8 have been expanded to illustrate how those risks can result in material misstatement of the financial statements.[178/]

Some individual commenters offered suggestions for refining or clarifying the discussion of the risk of material misstatement and its components. For example, one commenter suggested that the description of the risk of material misstatement should state that the risk exists "prior to the audit" to more clearly indicate that it is the company's risk. The Board agrees that the risk of material misstatement exists irrespective of the audit, while the risk of not detecting material misstatement is the auditor's risk. However, the suggested phrase could be misinterpreted, e.g., as implying that the auditor need not consider the risk of misstatements occurring during the audit.

177/ Paragraph 6 of Auditing Standard No. 8.

178/ Ibid.

The reproposed standard included a statement that inherent risk and control risk are the company's risks; they exist independently of the audit. One commenter suggested that the statement was not informative and suggested revising the standard to state that inherent risk and control risk are functions of the company's characteristics, but influence the auditor's actions. The Board agrees that more discussion of the auditor's consideration of inherent risk and control risk is appropriate. Thus, Auditing Standard No. 8 has been expanded to discuss the sources of evidence the auditor uses when assessing inherent risk and control risk.[179/] Also, the description of control risk in Auditing Standard No. 8 has been aligned with the discussion of internal control concepts in Auditing Standard No. 5.

One commenter expressed a concern that descriptions of inherent risk, control risk, and detection risk that included the phrase "that could be material, individually or in combination with other misstatements," may be misinterpreted by the auditor as a requirement to consider whether the combination of dissimilar risks will result in a material misstatement. The commenter suggested changing "combination" to "aggregate." However, the standard does not discuss the combination of risks but, rather, the risk of a misstatement that could be material, individually or in combination with other misstatements, which is consistent with the description of the auditor's evaluation of uncorrected misstatements in Auditing Standard No. 14, Evaluating Audit Results. Thus, the term "combination" was retained as proposed.

179/ Paragraph 8 of Auditing Standard No. 8.

e. Detection Risk

The reproposed standard indicated that detection risk is reduced by performing substantive procedures. Some commenters stated that the discussion of detection risk should be modified to indicate that auditors can reduce detection risk through procedures other than substantive procedures (e.g., risk assessment procedures and tests of controls). A commenter also suggested changing the sentence in the standard to refer to "audit procedures" instead of "substantive procedures."

The Board acknowledges that auditors might obtain evidence of misstatements through procedures other than substantive procedures. However, that does not diminish the auditor's responsibility to plan and perform substantive procedures for significant accounts and disclosures that are sufficient to provide reasonable assurance of detecting misstatements that would result in material misstatement of the financial statements. Changing "substantive procedures" to "audit procedures," as suggested by the commenter, is not consistent with AU sec. 319, Consideration of Internal Control in a Financial Statement Audit, and could be misunderstood by auditors, resulting in inadequate substantive procedures.[180/] To provide further clarification, Auditing Standard No. 8 has been revised to describe the role of risk assessment procedures and tests of

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[180/] AU secs. 319.81-.82. AU sec. 319, along with AU sec. 311, Planning and Supervision, AU sec. 312, Audit Risk and Materiality in Conducting an Audit, AU sec. 313, Substantive Tests Prior to the Balance Sheet Date, AU sec. 326, Evidential Matter, and AU sec. 431, Adequacy of Disclosure in Financial Statements, are superseded by the risk assessment standards.

controls in assessing the risk of material misstatement, which, in turn, affects the appropriate level of detection risk.[181/]

Some commenters expressed concerns that the reproposed standard did not adequately link the concepts of inherent risk and control risk to detection risk. They stated that a discussion on the relationship of these concepts is necessary for the auditor to determine the acceptable level of detection risk for the financial statement assertions, which, in turn, is used to determine the nature, timing, and extent of substantive procedures. The following discussion, which is adapted from AU sec. 319, was added to paragraph 10 of Auditing Standard No. 8: "The auditor uses the assessed risk of material misstatement to determine the appropriate level of detection risk for a financial statement assertion. The higher the risk of material misstatement, the lower the level of detection risk needs to be in order to reduce audit risk to an appropriately low level."[182/]

f. Integrated Audit Considerations

Auditing Standard No. 8 applies both to audits of financial statements only and to the financial statement audit portion of integrated audits. Audit risk in the audit of financial statements relates to whether the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, while audit risk in an audit of internal control over financial reporting ("audit of internal control") relates to

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181/ Paragraphs 8-9 of Auditing Standard No. 8.

182/ Paragraph 10 of Auditing Standard No. 8.

whether the auditor expresses an inappropriate audit opinion when one or more material weaknesses exist. The two forms of audit risk are related, however, and Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, indicates that the risk assessment procedures apply to both the audit of financial statements and the audit of internal control.

Some commenters suggested revisions to the first paragraph and the first footnote of the reproposed standard to clarify how the concepts of audit risk in this standard apply to audits of financial statements only and to integrated audits. The first paragraph has been revised to indicate that Auditing Standard No. 8 applies to either an audit of financial statements only or to an integrated audit. The first footnote also has been revised to clarify that, in integrated audits, the risks of material misstatement are the same for both the audit of financial statements and the audit of internal control.

4. Auditing Standard No. 9 – Audit Planning

a. Background

Auditing Standard No. 9 describes the auditor's responsibilities for planning an integrated audit or an audit of financial statements only.

b. Planning and Supervision

The original proposed standard and the reproposed standard discussed both audit planning and supervision, similar to AU sec. 311. Some commenters observed that audit planning and supervision should be covered in separate standards.

The Board agrees that audit planning and supervision of engagement team members are distinct activities that should be covered in separate standards. Accordingly, the Board has divided the requirements of the reproposed planning and supervision standard into separate standards. Dividing the requirements for planning and supervision into separate standards does not affect the auditor's responsibilities for planning the audit or supervising the work of engagement team members.

c. Responsibilities of the Engagement Partner

AU sec. 311 stated, "The auditor with final responsibility for the audit may delegate portions of the planning and supervision of the audit to other firm personnel." Auditing Standard No. 9 uses the term "engagement partner" instead of "auditor with final responsibility for the audit" and states more directly that the engagement partner is responsible for properly planning the audit. The standard also allows the engagement partner to seek assistance from appropriate engagement team members in fulfilling his or her planning responsibilities. Because the requirements in Auditing Standard No. 9 apply to the engagement partner and engagement team members who assist the engagement partner in planning the audit, the standard uses the term "auditor," and a footnote was added to clarify that the requirements in the standard apply to the engagement partner and other engagement team members who participate in planning the audit.

d. Preliminary Engagement Activities

The reproposed standard included a note in paragraph 6 stating that the decision regarding continuance of the client relationship and the determination of compliance with independence and ethics requirements were not limited to preliminary engagement activities and should be reevaluated with changes in circumstances. One commenter expressed concern that the note did not describe the changes in circumstances for which it would be appropriate for the auditor to reevaluate these decisions. The acceptance and continuance of the client relationship are discussed in QC sec. 20, System of Quality Control for a CPA Firm's Accounting and Auditing Practice. Other PCAOB standards discuss certain circumstances that warrant reevaluating the client relationship.[183/] Auditors also may reevaluate their engagement acceptance decision for other reasons. However, because auditors must comply with independence and ethics requirements throughout the audit, the note was moved in Auditing Standard No. 9 to modify paragraph 6.b. and revised to state that determination of compliance with independence and ethics requirements is not limited to preliminary engagement activities and should be reevaluated upon changes in circumstances.

[183/] See, e.g., paragraphs .18-.21 of AU sec. 317, Illegal Acts by Clients.

e. Planning Activities

The reproposed standard stated that, as part of establishing the audit strategy and audit plan, the auditor should evaluate whether certain matters specified in the standard are important to the company's financial statements and internal control over financial reporting ("internal control") and, if so, how those matters would affect the auditor's procedures. The requirement in the reproposed standard was the same as in paragraph 9 of Auditing Standard No. 5, thus extending its application to an audit of financial statements.

Evaluation of the matters listed in paragraph 7 of Auditing Standard No. 9 can lead auditors to develop more effective audit strategies and audit plans. For example, evaluation of those matters can highlight areas that might warrant additional attention during the auditor's risk assessment procedures, which, in turn, could affect the audit procedures performed in response to the risks of material misstatement. Also, evaluation of the internal control related matters can help the auditor develop an appropriate audit strategy, e.g., in determining accounts for which reliance on controls might be appropriate in the audit of financial statements.

Some commenters suggested changes to the requirement, including deleting some of the matters discussed in the requirement, moving other matters elsewhere within the standard, or making specific revisions to the language of the standard. Also, some commenters suggested using "should consider" instead of "should evaluate."

The Board considered the suggested changes to the standard and determined that those changes would not substantially improve the standard. Also, it is important for the language in this requirement to be identical to the language in Auditing Standard No. 5 to emphasize that this required procedure is to be performed only once in an integrated audit, with the results of the procedure to be applied in planning both the financial statement audit and the audit of internal control. Also, reframing the requirement from "should evaluate" to "should consider" would weaken the requirement. Therefore, Auditing Standard No. 9 retains the wording from the reproposed standard.

f. Audit Strategy and Audit Plan

Auditing Standard No. 9 requires the auditor to take into account certain matters when establishing the overall audit strategy, including the reporting objectives of the engagement and the nature of the communications required by PCAOB standards; the factors that are significant in directing the activities of the engagement team; the results of preliminary engagement activities and the auditor's evaluation of certain important matters; and the nature, timing, and extent of resources necessary to perform the engagement.[184/] These matters generally relate to information that auditors obtain through other required procedures. One commenter suggested that this requirement should discuss the need for specialists. Auditing Standard No. 9 was revised to include a reference to

[184/] Paragraph 9 of Auditing Standard No. 9.

paragraph 16 regarding the requirement for the auditor to determine whether specialized skill or knowledge is needed to perform the engagement.

The reproposed standard required the auditor to develop and document an audit plan that includes the planned nature, timing, and extent of the risk assessment procedures. One commenter suggested that it was unnecessary to document the timing of the risk assessment procedures because risk assessment is an ongoing process that occurs throughout the execution of the audit. Auditing Standard No. 9 retains the requirement to document the timing of the risk assessment procedures. Identifying and appropriately assessing the risks of material misstatement provide a basis for designing and implementing responses to the risks of material misstatement, so the timing of the risk assessment procedures is important to determine the timing of other audit procedures.

The reproposed standard also required the auditor to develop and document the planned nature, timing, and extent of tests of controls and substantive procedures. One commenter suggested that the requirement should specify that the audit plan include planned tests at the "relevant assertion level." Auditing Standard No. 9 retains the requirement as reproposed. Audit procedures are not performed only at the assertion level, e.g., certain general audit procedures and tests of certain entity-level controls in the audit of internal control over financial reporting. Therefore, it is not appropriate to update the standard with the suggested language.

g. Requirements for Multi-location Engagements

Auditing Standard No. 9 establishes requirements that apply to audits of companies with operations in multiple locations or business units. Auditing Standard No. 9 requires the auditor to determine the extent to which audit procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual locations or business units. The auditor is required to assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit. Auditing Standard No. 9 also lists factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures. These requirements are risk-focused and aligned with the requirements in Auditing Standard No. 5.

An example was added to one of the factors in Auditing Standard No. 9 to highlight that the auditor's consideration of risks associated with a location or business unit includes whether significant unusual transactions are executed at that location or business unit, e.g., whether certain transactions were conducted at the location or business unit to achieve a particular accounting result. AU sec. 316 already requires the auditor to perform procedures regarding significant unusual transactions.

The reproposed standard included a statement¸ similar to Auditing Standard No. 5, that "The direction in paragraph 5 of Proposed Auditing Standard, The Auditor's Responses to the Risks of Material Misstatement, regarding incorporating an element of unpredictability in the auditing procedures means that the auditor should vary the nature, timing, and extent of audit procedures at locations or business units from year to year." Some commenters stated that the statement in the reproposed standard was unnecessarily prescriptive. After considering the comments received, the requirement regarding unpredictability was removed from the audit planning standard, and the requirements in Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement, regarding incorporating an element of unpredictability were expanded to include discussion of varying the testing in the selected locations.[185/] However, this does not change the requirements in Auditing Standard No. 5 regarding incorporating unpredictability in testing controls at individual locations in audits of internal control.[186/]

The reproposed standard included a requirement for the auditor to determine the extent to which auditing procedures should be performed at selected locations or business

[185/] Paragraph 5 of Auditing Standard No. 13.

[186/] Paragraphs 61 and B13 of Auditing Standard No. 5.

units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatements. One commenter was concerned that the use of the term "consolidated financial statements" is inconsistent with the terminology used elsewhere in the standards and that the financial statements of companies with multiple divisions might not meet the definition of consolidated. The use of "consolidated financial statements" is consistent with the term used in Auditing Standard No. 5. The use of the term "consolidated" applies to situations in which the company has multiple locations or business units. Auditing Standard No. 9 retains the language as reproposed.

Some commenters requested clarification on how the requirements are expected to be applied in audits in which part of the work is performed by other auditors of financial statements of individual locations or business units that are included in the consolidated financial statements. A paragraph was added to Auditing Standard No. 9 to clarify that the auditor should apply the requirements in paragraphs 11-13 to determine the locations or business units for testing when the auditor plans to use the work and reports of other independent auditors who have audited the financial statements of one or more of the locations or business units (including subsidiaries, divisions, branches, components, or investments) that are included in the consolidated financial statements. AU sec. 543, Part of Audit Performed by Other Independent Auditors, describes the auditor's responsibilities when the auditor uses the work and reports of other independent auditors.[187/]

h. Persons with Specialized Skill or Knowledge

Auditing Standard No. 9 indicates that the auditor should determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results. The responsibility has been extended from a similar requirement in AU sec. 311 regarding considering whether specialized information technology ("IT") skill or knowledge is needed in an audit. The requirement was extended to specialized skill or knowledge in areas besides IT, e.g., valuation specialists, actuarial specialists, income tax specialists, and forensic specialists, because of the prevalent use of such individuals by auditors.

The reproposed standard included a note that described the term "specialized skill or knowledge" as persons engaged or employed by the auditor who have specialized skill or knowledge. Some commenters suggested that this note be removed because paragraph 17 included a similar description. The note was removed from Auditing Standard No. 9 because it was unnecessary and redundant.

One commenter suggested revising the standard to require the auditor to consider using a fraud specialist. The suggested requirement to consider using a fraud specialist

[187/] Paragraph 14 of Auditing Standard No. 9.

was not added to Auditing Standard No. 9 because the requirement in the reproposed standard already covers fraud specialists, and the types of specialized skill or knowledge that might be needed on a particular audit depend on the particular circumstances and the skill and knowledge of the engagement team.

Some commenters suggested that the requirements relating to the involvement of specialists be reframed as "assisting" the auditor. Such a formulation is too narrow to describe the range of involvement of specialists, which could include providing assistance to the auditor or actually performing audit procedures.

Paragraph 17 of Auditing Standard No. 9 describes the required level of knowledge of the subject matter in terms of the general types of procedures that the auditor should be able to perform with regard to the person with specialized skill or knowledge. Paragraph 17, by itself, does not impose procedural requirements for working with persons with specialized skill or knowledge because those responsibilities already are described in either the supervision provisions of Auditing Standard No. 10, Supervision of the Audit Engagement, or AU sec. 336, Using the Work of a Specialist, as applicable.

5. Auditing Standard No. 10 – Supervision of the Audit Engagement

a. Background

Auditing Standard No. 10 sets forth requirements for supervising the audit engagement, including supervising the work of engagement team members.

Auditing Standard No. 10 retains the basic requirements regarding supervision from AU sec. 311, with changes to align the requirements more closely with the other risk assessment standards. Auditing Standard No. 10 does not change the responsibilities for supervision from those in the supervision section of the reproposed standard on audit planning and supervision. However, the language in the standard has been revised in certain respects to describe more directly the supervisory responsibilities of the engagement partner and engagement team members who assist the engagement partner in supervision. As discussed later in this section, the Board has separate standards-setting projects regarding specialists and principal auditors, which will likely result in changes to the auditor's responsibilities regarding the auditor's use of specialists and use of other auditors, and, in turn, may result in changes to Auditing Standard No. 10.

b. Planning and Supervision

As discussed in section II.C.4.b., the original proposed standard and the reproposed standard included requirements for both audit planning and supervision, similar to AU sec. 311. Some commenters observed that audit planning and supervision should be covered in separate standards.

The Board agrees that audit planning and supervision of engagement team members are distinct activities that should be covered in separate standards. Accordingly, the Board has divided the requirements of the planning and supervision standard into separate standards. Dividing the requirements for planning and supervision into separate standards does not affect the auditor's responsibilities for planning the audit or supervising the work of engagement team members.

c. Objective

When the requirements for planning and supervision were divided into separate standards, the objective for supervision of the work of engagement team members was adapted from the elements of proper supervision in the reproposed standard. Auditing Standard No. 10 states, "The objective of the auditor is to supervise the audit engagement, including supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached." The revised objective does not alter the supervision responsibilities included in the original proposed standard or the reproposed standard.

d. Responsibilities of the Engagement Partner

AU sec. 311 stated, "The auditor with final responsibility for the audit may delegate portions of the planning and supervision of the audit to other firm personnel." Auditing Standard No. 10 uses the term "engagement partner" instead of "auditor with final responsibility for the audit."

Auditing Standard No. 10 states that the engagement partner is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for proper supervision of the work of engagement team members and for compliance with PCAOB standards, including standards regarding using the work of specialists,[188/] other auditors,[189/] internal auditors,[190/] and others who are involved in testing controls.[191/] As discussed previously, as the Board considers changes to the auditor's responsibilities regarding the auditor's use of specialists and use of other auditors, it also may consider changes to Auditing Standard No. 10.

Auditing Standard No. 10 allows the engagement partner to seek assistance from appropriate engagement team members in fulfilling his or her responsibilities pursuant to

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188/ See Section II.C.5.f. .

189/ Ibid.

190/ AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.

191/ Paragraphs 16-19 of Auditing Standard No. 5.

the standard. Engagement team members who assist the engagement partner in supervision should comply with the relevant requirements of Auditing Standard No. 10. The requirements in PCAOB standards for assignment of responsibilities to engagement team members also apply to assignments that involve assisting the engagement partner with his or her responsibilities pursuant to the standard.[192/]

e. Supervision of the Work of Engagement Team Members

Previously adopted PCAOB standards use either the term "engagement team members" or the term "assistants." Auditing Standard No. 10 uses "engagement team members," which is consistent with the other risk assessment standards. The Board is amending other PCAOB standards to conform to this terminology.

Auditing Standard No. 10 describes the required supervisory activities that should be performed by the engagement partner and, as applicable, by other engagement team members with supervisory responsibilities.[193/] Those activities include informing engagement team members of their responsibilities and information relevant to those responsibilities, directing engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other

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[192/] See, e.g. AU sec. 230.06 and paragraph 5 of Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

[193/] Paragraph 5 of Auditing Standard No. 10.

engagement team members performing supervisory activities, and reviewing the work of engagement team members as described in the standard.

Auditing Standard No. 10 describes the factors that should be taken into account in determining the necessary extent of supervision, i.e., the extent of supervision necessary so that the work of engagement team members is performed as directed and appropriate conclusions are formed based on the results of their work.[194/] Factors that affect the necessary extent of supervision include the risks of material misstatement, the nature of work assigned to the engagement team member, and the nature of the company, which includes the organizational structure of the company and its size and complexity. The extent of supervision of the work of an individual engagement team member increases or decreases, but cannot be eliminated, based on those factors. For example, the extent of supervision should be commensurate with the risks of material misstatement, which means, among other things, that the higher risk areas of the audit require more supervisory attention from the engagement partner.

One commenter suggested that the standard provide examples of "levels of supervision in relation to review," such as face-to-face review when reviewing higher risk areas. Auditing Standard No. 10 does not prescribe a particular method of review, so the engagement partner can determine the most effective way to comply with the

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[194/] Paragraph 6 of Auditing Standard No. 10.

requirements regarding the necessary nature of supervisory activities and necessary extent of supervision.

f. Persons with Specialized Skill or Knowledge and Other Auditors, Accounting Firms, and Individual Accountants

Auditing Standard No. 10 states that the engagement partner is responsible for, among other things, compliance with PCAOB standards regarding using of the work of specialists and refers to AU sec. 336. AU sec. 336 applies to situations in which the auditor engages a specialist in an area other than accounting or auditing and uses the work of that specialist as audit evidence.[195/] Paragraphs 5-6 of Auditing Standard No. 10 describe the nature and extent of the supervisory activities necessary for proper supervision of a person with specialized skill or knowledge who participates in the audit and is either (a) employed by the auditor or (b) engaged by the auditor to provide services in a specialized area of accounting or auditing. AU sec. 336 has been amended to clarify when the auditor should look to the supervisory requirements in Auditing Standard No. 10 instead of AU sec. 336.

[195/] AU sec. 336 also applies to situations in which the auditor uses the work of a specialist engaged or employed by management. The discussion in this section of the release focuses on the auditor's use of specialists who are employed or engaged by the auditor.

AU sec. 543 describes the principal auditor's[196/] responsibilities for using the work and reports of other independent auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented. The principal auditor should look to the requirements in AU sec. 543[197/] in those situations. For situations in which the auditor engages an accounting firm or individual accountants to participate in the audit engagement and AU sec. 543 does not apply,[198/] the auditor should supervise them in accordance with the requirements of Auditing Standard No. 10. AU sec. 543 has been amended to emphasize those points.

It should be noted, however, that the Board has separate standards-setting projects regarding specialists and principal auditors, which will include comprehensive reviews of AU sec. 336 and AU sec. 543, respectively, in light of, among other things, observations from the Board's inspection activities. Those projects will likely result in changes to the auditor's responsibilities regarding the auditor's use of specialists and use of other auditors, and, in turn, may result in changes to Auditing Standard No. 10.

196/ AU sec. 543 uses the term "principal auditor" to refer to the auditor who issues the audit report on the financial statements presented.

197/ For integrated audits, see also paragraphs C8-C11 of Auditing Standard No. 5.

198/ Examples of situations that are not covered by AU sec. 543 include loan staff arrangements.

g. Differences of Opinion within an Engagement Team

The original proposed standard included a requirement, adapted from AU sec. 311.14, that the engagement partner and other engagement team members should make themselves aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among the engagement team members. Since the intention of including this provision was to require adequate documentation of disagreements, this paragraph was removed from the reproposed standard, and the documentation requirements from the original proposed standard were incorporated into an amendment to Auditing Standard No. 3, Audit Documentation.[199/] The documentation requirements regarding disagreements among members of the engagement team or with others consulted on the engagement about final conclusions reached on significant accounting or auditing matters include documenting the basis for the final resolution of those disagreements. If an engagement team member disagrees with the final conclusions reached, he or she should document that disagreement.

One commenter indicated concern that the requirement for the engagement partner and other engagement team members to be aware of how disagreements should be handled has been removed. The commenter indicated that disagreements are a sensitive area and that it is important that engagement team members are aware of how disagreements should be handled. In connection with the requirement to direct

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[199/] Paragraph 12.d. of Auditing Standard No. 3.

engagement team members to bring significant accounting and auditing issues to the attention of the engagement partner or other engagement team members performing supervisory activities, Auditing Standard No. 10 also states that each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or the auditor's report regardless of how those disagreements or concerns may have arisen.[200/]

6. Auditing Standard No. 11 – Consideration of Materiality in Planning and Performing an Audit

a. Background

Auditing Standard No. 11 discusses the auditor's responsibilities for applying the concept of materiality, as described by the courts in interpreting the federal securities laws, in planning the audit and determining the scope of the audit procedures. The standard applies to integrated audits and audits of financial statements only.

b. Materiality in the Context of an Audit

Auditing Standard No. 11 discusses the concept of materiality that is applicable to audits performed in accordance with PCAOB standards, which is the articulation of

[200/] Note to paragraph 5.b. of Auditing Standard No. 10.

materiality used by the courts in interpreting the federal securities laws.[201] The Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[202]

Some commenters questioned the use of the court's articulation in the reproposed standard and suggested that this articulation might be difficult for auditors to apply. Also, some commenters asked whether the use of this articulation of materiality, in contrast to the quotation from a FASB Concept Statement[203] used in AU sec. 312 was intended to result in a change in audit practice.

Although the discussion of materiality in the accounting literature might help auditors understand how accounting standards-setters view materiality in the context of preparation and presentation of financial statements, the concept of materiality that is relevant for audits to which PCAOB standards apply is the concept used by the courts in interpreting the federal securities laws. Because the auditor has a responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial

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201/ Paragraph 2 of Auditing Standard No. 11.

202/ See TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

203/ Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information. FASB Concepts Statements are not included in FASB's Codification of Accounting Standards.

statements, it is important for the auditor to plan and perform his or her audit procedures based on the applicable concept of materiality. Accordingly, Auditing Standard No. 11 uses the concept of materiality articulated by the courts.

Because the courts' articulation of the concept of materiality is not new, using that articulation in Auditing Standard No. 11 is not intended to result in changes in practice for most auditors. Auditing Standard No. 11 emphasizes that an auditor's consideration of materiality should reflect matters that would affect the judgment of a reasonable investor.

c. Establishing a Materiality Level for the Financial Statements as a Whole

Auditing Standard No. 11 requires the auditor to establish an appropriate materiality level for the financial statements as a whole.[204/] This materiality level should be established in light of the particular circumstances based on factors that could influence the judgment of a reasonable investor. The standard states that this requirement includes consideration of the company's earnings and other relevant factors. This statement is intended to emphasize that a company's net earnings are often an important factor in the total mix of information available to a reasonable investor, but Auditing Standard No. 11 does not require the use of earnings as the basis for the established materiality level in all cases. Other factors besides earnings might be more relevant depending on the particular circumstances, e.g., based on a company's industry or

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204/ Paragraph 6 of Auditing Standard No. 11.

situations in which the company's earnings were near zero. Auditors are expected to consider the factors that would be relevant to the judgment of a reasonable investor.

d. Qualitative Considerations

The concept of materiality involves consideration of both quantitative and qualitative factors.[205/] Under Auditing Standard No. 11, qualitative considerations can affect the auditor's establishment of materiality levels in the following ways:

- Establishing a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This involves matters such as consideration of the elements of the financial statements that are more important to a reasonable investor and the level of misstatements that would influence the judgment of a reasonable investor.

- Establishing lower levels of materiality for certain accounts or disclosures when, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. The requirement in the standard[206/] is consistent with the

[205/] Paragraph 3 of Auditing Standard No. 11.

[206/] Paragraph 7 of Auditing Standard No. 11.

principle of considering the judgment of a reasonable investor when establishing materiality levels because it recognizes that, in certain circumstances, misstatements in some accounts might have more significant consequences than in other accounts. The following are examples of such circumstances:

- o Laws, regulations, or the applicable financial reporting framework affect investors' expectations about the measurement or disclosure of certain items, e.g., related party transactions and compensation of senior management.

- o Significant attention has been focused on a particular aspect of a company's business that is separately disclosed in the financial statements, e.g., a recent business acquisition.

- o Certain disclosures are particularly important to investors in the industry in which the company operates.

Auditing Standard No. 11 does not allow the auditor to establish a materiality level for an account or disclosure at an amount that exceeds the materiality level for the financial statements as a whole.

The reproposed standard included a statement, adapted from AU sec. 312, that ordinarily it is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors.[207/] One commenter suggested removing the word "ordinarily" from the statement because, in the commenter's view, it is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors. Auditing Standard No. 11 retains the statement as proposed. This statement reflects the principle that judgments about whether a particular misstatement is material involve consideration of the particular circumstances, including the nature of the misstatement and its effect on the financial statements. Also, if an auditor is aware of potential misstatements that would be material based on qualitative factors, he or she has a responsibility to design audit procedures to detect such misstatements.

e. Tolerable Misstatement

The reproposed standard required the auditor to determine tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level.[208/] Tolerable misstatement is a concept used in determining the scope of audit procedures. AU sec. 350, *Audit Sampling*, indicates that tolerable misstatement is the maximum amount of misstatement in an account or a class of transactions that may exist without causing the financial statements to be materially misstated.[209/] Tolerable misstatement is required to be set at an amount

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[207/] AU sec. 312.20.

[208/] Paragraphs 8-9 of Auditing Standard No. 11.

[209/] AU sec. 350.18.

less than the materiality level for the financial statements as a whole and for particular accounts or disclosures, if lower materiality levels were established for particular accounts or disclosures.

Some commenters suggested replacing the term "tolerable misstatement" in the reproposed standard with the term "performance materiality," which is the term used in the International Standards on Auditing ("ISAs").

The Board decided to retain the term "tolerable misstatement" in its standards. The concept of tolerable misstatement is already understood by auditors, and the Board is not seeking to change the concept as described in PCAOB standards. Because the term "performance materiality" uses the word "materiality," it could be misunderstood, e.g., by nonauditors, as having a meaning other than that intended in the standard. The concept of materiality that applies to financial statements of companies that are audited in accordance with PCAOB standards is rooted in case law and reflects a reasonable investor's perspective. In contrast, tolerable misstatement is a concept used in audit scoping decisions at the account level, considering potential uncorrected and undetected misstatement.

One commenter stated that the requirement to establish tolerable misstatement eliminated the need to establish a lower level of materiality for particular accounts or disclosures. However, the two concepts are designed for different purposes. The requirement to establish a lower materiality level is intended to address the need for a lower threshold when, in light of the particular circumstances, misstatements of lesser amounts have a substantial likelihood of influencing the judgment of a reasonable investor. As mentioned previously, tolerable misstatement is a concept used in audit scoping decisions at the account level, considering potential uncorrected and undetected misstatement.

The reproposed standard also required the auditor to take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of financial statements of prior periods. One commenter suggested that the Board should clarify its intent regarding this requirement and provide additional guidance regarding its application. Tolerable misstatement is affected by the expected level of misstatement in the account or disclosure, and the nature, cause, and amount of misstatements from prior periods are relevant to developing expectations about the level of misstatement. Generally, as the expected level of misstatement increases, the amount of tolerable misstatement decreases.

f. Consideration of Materiality for Multi-location Engagements

The reproposed standard included requirements for establishing materiality levels in multi-location engagements. The reproposed standard stated that when the auditor plans to perform procedures at selected locations or business units, the auditor should establish the materiality level for the individual locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements. The reproposed standard also stated that the materiality level for the selected locations or business units generally should be lower than the materiality level for the consolidated financial statements. Those requirements were an application of the fundamental principles to audits of consolidated financial statements of companies with multiple locations or business units.

Some commenters suggested removing the word "generally" as it could be misinterpreted as permitting the use of the materiality level for the consolidated financial statements as a whole for planning and performing audit procedures at the individual location or business unit level. Other commenters questioned how the requirements would be applied when a principal auditor makes reference to the report of another auditor in the auditor's report on consolidated financial statements in accordance with AU sec. 543.

After considering the comments, the Board has made certain clarifying revisions to the requirements for multi-location engagements.[210/] First, the language in the standard has been revised to use term "tolerable misstatement" for an individual location to more clearly distinguish that term from the materiality level for the financial statements as a whole. In addition, the requirements were revised to state that tolerable misstatement for

[210/] Paragraph 10 of Auditing Standard No. 11.

a location or business unit should be less than the materiality level for the financial statements as a whole. The word "generally" was removed from the requirements to reduce the risk of misinterpretation of the provision. Also, the phrase "to be used in performing audit procedures" has been removed from the requirement to determine tolerable misstatement for the individual locations or business units to avoid a misinterpretation about the principal auditor's responsibilities for situations in which the principal auditor makes reference to the report of the other auditor in accordance with AU sec. 543. Auditing Standard No. 11 requires the principal auditor to determine tolerable misstatement for the location or business unit audited by the other auditor, but the principal auditor is not expected to impose that determination of tolerable misstatement on the other auditor. Rather, tolerable misstatement for the location or business unit audited by the other auditor would be relevant to certain requirements under AU sec. 543[211/] and in determining an appropriate amount of tolerable misstatement for the remaining locations or business units included in the consolidated financial statements.

g. Reevaluating the Materiality Level and Tolerable Misstatement

The reproposed standard stated that the established materiality level and tolerable misstatement should be reevaluated if changes in the particular circumstances or

[211/] For example, AU sec. 543.10 states that the auditor should adopt measures to assure the coordination of the principal auditor's activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements.

additional information comes to the auditor's attention that are likely to influence the judgment of a reasonable investor. In addition, the reproposed standard provided examples of situations that would require such reevaluation, and additional examples were discussed in the release accompanying the reproposed standards.

Some commenters suggested that the examples in the release should be included in the reproposed standard. The examples in Auditing Standard No. 11 have been revised to clarify the types of situations that would require reevaluation of the established materiality level and tolerable misstatement.

The reevaluation required by Auditing Standard No. 11 is important because if that reevaluation results in a lower materiality level or levels and tolerable misstatement than the auditor's initial determination, the standard states that the auditor should (1) evaluate the effect, if any, of the lower amount or amounts on his or her risk assessments and audit procedures and (2) modify the nature, timing, and extent of audit procedures as necessary to obtain sufficient appropriate audit evidence.[212/]

Auditing Standard No. 11 does not allow the auditor to modify the established level or levels of materiality and tolerable misstatement solely because they are approximately equal to or are exceeded by the amount of uncorrected misstatements. Such a practice is inconsistent with the requirement to reevaluate the established materiality level or levels or tolerable misstatement if changes in the particular circumstances or additional information come to the auditor's attention that are likely to

[212/] Paragraph 12 of Auditing Standard No. 11.

affect the judgments of a reasonable investor. Rather, Auditing Standard No. 14 establishes requirements for evaluating uncorrected misstatements[213/] and describes the auditor's responsibilities in situations in which uncorrected misstatements approach established materiality level or levels used in planning and performing an audit.[214/]

7. Auditing Standard No. 12 – Identifying and Assessing Risks of Material Misstatement

a. Background

Auditing Standard No. 12 describes the auditor's responsibilities for the process of identifying and assessing risks of material misstatement in an audit of financial statements only and in an integrated audit. This process includes (1) performing information-gathering procedures, known as risk assessment procedures, and (2) identifying and assessing the risks of material misstatement using information obtained from the risk assessment procedures.

As discussed in the release accompanying the reproposed standards, the requirements in this standard are intended to improve the auditor's risk assessments and ability to focus on areas of increased risk in audits of financial statements only and in integrated audits. The effectiveness of a risk-based audit depends on whether the auditor identifies the risks of material misstatement and has an appropriate basis for assessing

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213/ Paragraphs 17-23 of Auditing Standard No. 14.

214/ Paragraph 14.b. of Auditing Standard No. 14.

those risks. Inappropriate identification or assessment of risks of material misstatements can lead to overlooking relevant risks to the financial statements, e.g., business conditions that affect asset quality or create pressures to manipulate the financial statements, or assessing risks too low without having an appropriate basis for the assessment. In turn, these situations can lead to misdirected or inadequate audit work.

Auditing Standard No. 12 employs a top-down approach to risk assessment. Such an approach begins at the financial statement level and with the auditor's overall understanding of the company and its environment and works down to the significant accounts and disclosures and their relevant assertions. Also, the requirements for performing risk assessment procedures are designed to be scalable to companies of varying size and complexity.

In an integrated audit, the risks of material misstatement affect both the audit of financial statements and the audit of internal control, so the risk assessment process described in Auditing Standard No. 12 is for a single process that applies to both the audit of financial statements and the audit of internal control. Auditing Standard No. 12 seeks to enhance the integration of the audit of financial statements with the audit of internal control by aligning these risk assessment standards with Auditing Standard No. 5. Accordingly, Auditing Standard No. 12 reflects certain foundational risk assessment principles from Auditing Standard No. 5 that also apply to audits of financial statements. On the other hand, the provisions of this standard also are designed to be tailored for audits of financial statements only, e.g., the requirements relating to the understanding of internal control over financial reporting.

b. Objective

Some commenters recommended that the Board revise the objective in the reproposed standard to indicate that the auditor's identification and assessment of risks are through understanding of the company and its environment. The objective in Auditing Standard No. 12 was retained from the reproposed standard. The revision suggested by the commenters is too narrow because Auditing Standard No. 12 requires other risk assessment procedures beyond obtaining an understanding of the company and its environment.

c. Performing Risk Assessment Procedures

The overarching requirement for risk assessment procedures in Auditing Standard No. 12 is that the auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of the risks of material misstatement, whether due to error or fraud, and to design further audit procedures.[215/] Auditing Standard No. 12 discusses the auditor's responsibilities for determining and

[215/] Paragraph 4 of Auditing Standard No. 12. The phrase "design further audit procedures" applies to substantive procedures and to tests of controls in the audit of financial statements and the audit of internal control over financial reporting.

performing the risk assessment procedures necessary to satisfy that overarching requirement.[216/]

Risks of material misstatement may exist at the financial statement level or at the assertion level. Risks of material misstatement also can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. Since the risks of material misstatement come from various sources, the auditor's risk assessment procedures need to encompass both external factors and company-specific factors. Auditing Standard No. 12 requires the following risk assessment procedures:

- Obtaining an understanding of the company and its environment;[217/]
- Obtaining an understanding of the company's internal control over financial reporting;[218/]

[216/] Paragraphs 5-58 of Auditing Standard No. 12.

[217/] Paragraphs 7-17 of Auditing Standard No. 12.

[218/] Paragraphs 18-40 of Auditing Standard No. 12.

- Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company;[219/]

- Performing analytical procedures;[220/]

- Conducting a discussion among engagement team members regarding the risks of material misstatement;[221/] and

- Inquiring of the audit committee, management, and others within the company about the risks of material misstatement.[222/]

The reproposed standard required the auditor to perform risk assessment procedures that are designed to help the auditor identify the areas of greater risk, appropriately assess those risks, and design and perform further audit procedures to address risks of material misstatements in the financial statements, whether due to error or fraud. One commenter suggested adding the phrase "and to design further audit procedures focused on the areas of greatest risk" to the end of the sentence in paragraph

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219/ Paragraphs 41-45 of Auditing Standard No. 12.

220/ Paragraphs 46-48 of Auditing Standard No. 12.

221/ Paragraphs 49-53 of Auditing Standard No. 12.

222/ Paragraphs 54-58 of Auditing Standard No. 12.

4. The suggested language is not included in Auditing Standard No. 12 because that principle is already addressed in Auditing Standard No. 13.

One commenter on the reproposed standard asked for more discussion of the connection between the components of audit risk and the risk assessment process. That discussion has been added to Auditing Standard No. 8.[223/]

d. Obtaining an Understanding of the Company and its Environment

Like the reproposed standard, Auditing Standard No. 12 requires the auditor to obtain an understanding of the company and its environment to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement ("obtaining an understanding of the company").[224/] These requirements are an expansion of requirements that were in AU sec. 311 regarding obtaining knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics as part of audit planning.[225/] The expanded requirements are intended to focus the auditor on the degree of "knowledge of the company" that is necessary for a risk-based audit and to explain how knowledge of the company informs the auditor's identification and assessment of risk.

223/ Paragraphs 8-11 of Auditing Standard No. 8.

224/ Paragraph 7 of Auditing Standard No. 12.

225/ AU secs. 311.06-.09.

Auditing Standard No. 12 requires that the understanding of the company and its environment include understanding the following:

- Relevant industry, regulatory, and other external factors;
- The nature of the company;
- The company's selection and application of accounting principles, including related disclosures;
- The company's objectives and strategies and those related business risks that might reasonably be expected to result in risks of material misstatement; and
- The company's measurement and analysis of its financial performance.[226/]

Auditing Standard No. 12 requires the auditor to evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.[227/] This requirement builds on the requirement in paragraph 7 of Auditing Standard No. 9 to evaluate whether, among other things, the extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting is important to the company's financial

226/ Paragraph 7 of Auditing Standard No. 12.

227/ Paragraph 8 of Auditing Standard No. 12.

statements and internal control over financial reporting and, if so, how those changes will affect the auditor's procedures. PCAOB standards have recognized that many risks of material misstatement arise due to changes in the company. For example, AU sec. 319 listed the following examples of circumstances that can result in risks or changes to existing risks: changes in operating environment; new personnel; new or revamped information systems; rapid growth; new technology; new business models, products, or activities; corporate restructurings; expanded foreign operations; and new accounting pronouncements.[228/]

Paragraphs 9-17 of Auditing Standard No. 12 explain more fully the necessary understanding of the preceding aspects of the company and its environment, e.g., what it means to obtain an understanding of the nature of the company. The discussion of relevant industry, regulatory, and other external factors is adapted from AU sec. 311. The discussion of the nature of the company is also adapted from AU sec. 311 and has been updated to reflect certain changes in business practices since AU sec. 311 was originally issued (e.g., to encompass alternative investments and financing arrangements and to recognize the development of new business models).

One commenter said that the requirement to obtain an understanding of the company and its environment should be revised because none of the aspects of the company and its environment listed in paragraph 7 is an event, condition, or company

[228/] AU sec. 319.38.

activity. However, the understanding of those aspects should lead the auditor to obtain an understanding of relevant events, conditions, and company activities. For example, obtaining an understanding of relevant industry, regulatory, and external factors helps an auditor understand the external conditions in which the company operates that represent risks of material misstatement at the financial statement level.

The reproposed standard contained a note about how the size and complexity of the company can affect the risks of misstatement and the controls necessary to address those risks. This note was intended to be a reminder to auditors that both size and complexity affect risks. One commenter stated that complexity rather than size is likely to heighten risk. Auditing Standard No. 12 retains the note as reproposed.[229/] The size and complexity of the company can affect the risks of misstatement and the controls necessary to address those risks. Scaling the audit is most effective as a natural extension of the risk-based approach and applies to all audits, and the requirements in Auditing Standard No. 12 are intended to be scalable to companies of varying size and complexity. Auditing Standard No. 12 contains certain notes regarding scaling the audit based on a company's size and complexity.

[229/] First note to paragraph 10 of Auditing Standard No. 12.

(i). Additional Procedures to Obtain an Understanding of the Company and its Environment

The reproposed standard presented a list of procedures that the auditor should consider performing as part of obtaining an understanding of the company and its environment. These procedures include reading public information about the company, observing or reading transcripts of earnings calls, obtaining an understanding of compensation arrangements with senior management, and obtaining information about significant unusual developments regarding trading activity in the company's securities. The auditor's decisions about whether to perform one or more of the additional procedures and the extent of those procedures depend on whether the matters addressed in those procedures are important to the company's internal control or financial statements and whether such procedures are necessary to meet the overall requirements for obtaining an understanding of the company and performing risk assessment procedures.

Members of the Board's Standing Advisory Group ("SAG") suggested that these matters could provide valuable information for identifying risks of material misstatement, e.g., to obtain information about business risks relevant to financial reporting or to identify incentives or pressures on management to manipulate financial results.[230/] Also, the Public Oversight Board, Panel on Audit Effectiveness, Report and Recommendations

230/ February 16, 2005. Webcasts of SAG meetings are available on the Board's website at: http://www.pcaobus.org/News_and_Events/Webcasts.

("PAE Report"), recommended that auditors consider published analysts' reports and forecasts when gaining an understanding of the company's business and industry, assessing risks, and evaluating identified misstatements.[231/]

Commenters requested clarification of the Board's expectations regarding these procedures and expressed concern that the broad language used to describe some of the procedures might lead auditors to expend considerable efforts to decide and document whether to perform certain procedures. This requirement is not intended to require auditors to make a specific determination about each bit of data to which a procedure might be applied, e.g., to document each individual item of publicly available information to decide whether it should be reviewed.

Instead, the intention is for auditors to consider whether and to what extent such procedures should be performed to achieve the objectives in paragraphs 4 and 7 of Auditing Standard No. 12. For example, observing the company's earnings calls and other meetings with investors are likely to provide important information about the measurement and review of the company's financial performance, particularly the performance measures monitored by investors and analysts. Likewise, an understanding of compensation arrangements with senior management often can provide important information about incentives or pressures on management to manipulate the financial statements.

[231/] Public Oversight Board, Panel on Audit Effectiveness, Report and Recommendations (August 31, 2000), p. 58.

Auditing Standard No. 12 was revised to clarify that considering whether to perform the procedures listed in paragraph 11 also includes consideration of the extent of the procedures.

(ii). Selection and Application of Accounting Principles, Including Related Disclosures

PCAOB standards require auditors to obtain an understanding of the accounting practices common to the industry and to evaluate the quality of a company's accounting principles as part of his or her response to fraud risks and in determining matters to be communicated to the audit committee.[232/] Auditing Standard No. 12 imposes a responsibility to obtain an understanding of the applicable financial reporting framework and to evaluate whether the company's selection and application of accounting principles are consistent with the applicable accounting framework and the accounting principles used in the relevant industry.[233/] Such procedures can provide important information for identifying relevant matters such as (1) accounts that are susceptible to misstatement, e.g., if an account balance is determined using accounting principles that are inconsistent with the applicable financial reporting framework or (2) more general conditions that affect risks of material misstatement, e.g., if the company's selection or application of

[232/] See AU sec. 316 and AU sec. 380, Communication With Audit Committees.

[233/] Paragraph 12 of Auditing Standard No. 12.

accounting principles is more aggressive than prevailing practices in the relevant industry.

In connection with obtaining an understanding of the applicable financial reporting framework and evaluating the company's selection and application of accounting principles, including related disclosures, Auditing Standard No. 12 requires the auditor to develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.[234/] The language in this requirement was revised to clarify that the auditor should develop an expectation about the disclosures as part of the risk assessment procedures and that the expectations should be based on the disclosures necessary for the fair presentation of the financial statements in conformity with the applicable financial reporting framework.

Auditing Standard No. 12 also presents a list of matters that, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles.[235/] The amount of auditor attention devoted to an individual matter would depend on its importance in meeting the overall requirements for obtaining an understanding of the company and performing risk assessment procedures.[236/]

[234/] Ibid.

[235/] Paragraph 13 of Auditing Standard No. 12.

[236/] Paragraphs 4 and 7 of Auditing Standard No. 12.

(iii). Company Objectives, Strategies, and Related Business Risks

The reproposed standard required the auditor to obtain an understanding of the company's objectives, strategies, and related business risks in order to identify those business risks that could reasonably be expected to result in material misstatement of the financial statements. The PAE Report recommended that auditors be required to obtain an understanding of the company's business risks.[237/]

Commenters on the reproposed standard requested additional discussion about business risks, including going concern risks, fraud risks, and how business risks can result in misstatements of the financial statements. Additional discussion has been added to Auditing Standard No. 8 and Auditing Standard No. 12.[238/]

Auditing Standard No. 12 discusses how business risks can lead to misstatements and provides examples of business risks that may result in a risk of material misstatement of the financial statements.[239/] However, the list of examples is meant to be illustrative rather than a checklist of factors to consider. Auditors would need to consider the business risks that are relevant to the particular company and industry. For example, in

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237/ PAE Report, p. 20.

238/ Paragraph 6 of Auditing Standard No. 8 and the note to paragraph 15 of Auditing Standard No. 12.

239/ Paragraphs 5 and 14-15 of Auditing Standard No. 12.

today's economic environment, business risks might include financing risks (e.g., access to necessary financing) or product risks (e.g., investments in certain financial products).

(iv). The Company's Measurement and Analysis of its Financial Performance

The risk assessment procedures in the reproposed standard included obtaining an understanding of the company's performance measures. The purpose of obtaining that understanding is to identify those performance measures, whether external or internal, that affect the risks of material misstatement. For example, understanding performance measures can help the auditor identify accounts or disclosures that might be susceptible to manipulation to achieve certain performance targets (or to conceal failures to achieve those targets) or to understand how management uses performance measures to monitor risks affecting the financial statements.

Commenters requested clarification regarding the examples of performance measures. A note was added to Auditing Standard No. 12 to explain the significance of the individual examples.[240/]

e. Obtaining an Understanding of Internal Control Over Financial Reporting

Auditing Standard No. 12 describes the auditor's responsibilities for obtaining an understanding of internal control over financial reporting ("understanding of internal control"). Auditing Standard No. 12 requires the auditor to obtain a sufficient

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240/ Paragraph 17 of Auditing Standard No 12.

understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.[241/] These requirements are, in substance, equivalent to those in AU sec. 319, but the formulation in the proposed standard is aligned more clearly with Auditing Standard No. 5. Like the requirements in AU sec. 319, the requirements in Auditing Standard No. 12 indicate that although the auditor's primary focus is on internal control over financial reporting, the auditor may obtain an understanding of controls related to operations or compliance objectives if they pertain to data that the auditor plans to use in applying auditing procedures.[242/]

Auditing Standard No. 12 sets forth certain principles regarding the sufficiency of the auditor's understanding of internal control. The size and complexity of the company; the auditor's existing knowledge of the company's internal control; the nature of the company's internal controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting affect the nature, timing, and extent of procedures necessary to obtain an understanding of internal control. For example, the auditor's procedures to obtain an understanding of internal control would be more extensive when the auditor plans to test controls more extensively (e.g., in an integrated

[241/] Paragraph 18 of Auditing Standard No. 12.

[242/] Paragraph 19 of Auditing Standard No. 12.

audit), the company's internal control is more complex, or the company's controls have changed significantly.

The reproposed standard stated that the auditor's understanding of internal control includes evaluating the design of controls and determining whether the controls are implemented. Commenters observed that the reproposed standard stated that walkthroughs that include the necessary procedures ordinarily are sufficient to evaluate design effectiveness, but the reproposed standard did not make a similar statement about the use of walkthroughs to determine whether controls have been implemented. Auditing Standard No. 12 has been revised to include a statement that walkthroughs that include the procedures described in the standard ordinarily are sufficient to determine whether a control has been implemented.[243/] Under Auditing Standard No. 12, as under AU sec. 319,[244/] the amount of audit attention devoted to design and operating effectiveness will vary based on the auditor's plan for testing controls. For example, if the auditor plans to test controls, more attention should be devoted to controls that the auditor plans to test.

(i). Obtaining an Understanding of Individual Components of Internal Control Over Financial Reporting

To describe the auditor's responsibilities for obtaining an understanding of internal control, it was necessary to describe the components of internal control over

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[243/] Paragraph 20 of Auditing Standard No. 12.

[244/] AU sec. 319.58.

financial reporting. The components described in Auditing Standard No. 12 are similar to those in AU sec. 319.[245/] Auditing Standard No. 12 also states that auditors may use other suitable, recognized frameworks[246/] in accordance with the provisions of the standard. If the auditor uses a suitable, recognized internal control framework with components that differ from those in the standard, the auditor should adapt the requirements in the standard for the components in the framework used.[247/]

(ii). Control Environment

Auditing Standard No. 12 requires the auditor to assess the following matters as part of obtaining an understanding of the control environment:

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and

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245/ Paragraph 21 of Auditing Standard No. 12.

246/ See Securities Exchange Act Release No. 34-47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

247/ Paragraph 22 of Auditing Standard No. 12.

- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.[248/]

Although this requirement is aligned with a similar requirement in Auditing Standard No. 5 for evaluating the control environment, the auditor's process for assessing the control environment in an audit of financial statements only is not expected to be the same as that required when expressing an opinion on internal control over financial reporting. For audits of financial statements only, Auditing Standard No. 12 allows the auditor to base his or her assessment on evidence obtained as part of obtaining an understanding of the control environment and other relevant knowledge possessed by the auditor.[249/]

Because of the importance of an effective control environment to address fraud risks, Auditing Standard No. 12 states that if the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor.[250/]

[248/] Paragraph 24 of Auditing Standard No. 12.

[249/] Ibid.

[250/] Paragraph 25 of Auditing Standard No. 12.

(iii) The Company's Risk Assessment Process

Auditing Standard No. 12 requires the auditor to obtain an understanding of management's risk assessment process for (a) identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud, (b) assessing the likelihood and significance of misstatements resulting from those risks, and (c) deciding about actions to address those risks.[251/] The standard also requires the auditor to obtain an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.[252/] Compliance with these requirements will help make sure that the auditor's risk assessments are appropriately informed by management's risk assessments and the controls that management put in place to address the risks.

(iv). Information and Communication

The reproposed standard required the auditor to obtain an understanding of the information system, including the related business processes, relevant to financial reporting. One commenter suggested removing the requirement to understand the company's business processes. The requirement was retained as reproposed.[253/] Obtaining an understanding of the company's business processes assists the auditor in obtaining an

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251/ Paragraph 26 of Auditing Standard No. 12.

252/ Paragraph 27 of Auditing Standard No. 12.

253/ Paragraph 28 of Auditing Standard No. 12.

understanding of how transactions are initiated, authorized, processed, and recorded. Also, the requirement to understand business processes is a recommendation in the PAE Report.[254] Auditing Standard No. 12 describes the necessary understanding of business processes to help auditors identify those business processes that are relevant to financial reporting.[255]

Auditing Standard No. 12 also contains requirements for understanding the period-end financial reporting process[256] and describes important elements of that process.[257] Because the period-end financial reporting process is a common source of potential misstatements, it is important for the auditor to have an adequate understanding of the aspects of the period-end financial reporting process in all audits, including audits of financial statements only. Auditing Standard No. 12 requires the auditor only to obtain an understanding[258] of the process, as compared to Auditing Standard No. 5, which requires the auditor also to evaluate that process in the audit of internal control.

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[254] PAE Report, p. 15.

[255] Paragraphs 28-32 of Auditing Standard No. 12.

[256] AU sec. 319.49 used the term "financial reporting process used to prepare the entity's financial statements," but Auditing Standard No. 12 uses the same term as used in Auditing Standard No. 5.

[257] Paragraphs 28 and 32 of Auditing Standard No. 12.

[258] Paragraph 20 of Auditing Standard No. 12 discusses procedures that the auditor performs to obtain an understanding of internal control.

To appropriately highlight the importance of IT risks in determining the scope of the audit, the standard requires the auditor to obtain an understanding of how IT affects the company's flow of transactions. The standard also contains a note that states that the identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the approach used to identify significant accounts and disclosures and their relevant assertions and, when applicable, to select the controls to test, as well as to assess risk and allocate audit effort.

Regarding the auditor's understanding of communication, one commenter suggested that the standard clarify that the auditor should understand how the company communicates financial reporting roles and responsibilities and significant matters relating to financial reporting. The requirement in Auditing Standard No. 12 has been revised to clarify that point.[259/]

(v). Control Activities

The reproposed standard required the auditor to obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures. As under AU sec. 319, a more extensive understanding of control activities is needed in areas in which the auditor plans to test controls. Thus, for purposes of evaluating the effectiveness of internal control over financial reporting in an integrated audit, the auditor's understanding of control activities

259/ Paragraph 33 of Auditing Standard No. 12.

encompasses a broader range of accounts and disclosures than that which is normally obtained in an audit of financial statements only.

Some commenters expressed concern that the language in the requirement could be misinterpreted as requiring the auditor to obtain an understanding of all controls, even in an audit of financial statements only in which the auditor does not plan to test controls. A few commenters suggested framing the requirement in terms of understanding control activities relevant to the audit.

The Board did not intend to expand the auditor's responsibilities for obtaining an understanding of control activities beyond what is required in AU sec. 319. The discussion in Auditing Standard No. 12 on obtaining an understanding of control activities has been revised, primarily using language adapted from AU sec. 319, to clarify that the substance of the requirement has not changed.[260/]

(vi). Performing Walkthroughs

The original proposed standard referred auditors to Auditing Standard No. 5 for a discussion of the performance of walkthroughs. Some commenters on the original proposed standard stated that the standard should include a discussion of walkthroughs rather than referring to Auditing Standard No. 5. The reproposed standard included a discussion of performing walkthroughs as part of meeting certain specified objectives,

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[260/] AU sec. 319.42 and paragraph 34 of Auditing Standard No. 12.

which paralleled a requirement in Auditing Standard No. 5[261/] regarding understanding likely sources of potential misstatements. Some commenters expressed concerns that the discussion would lead to unnecessary walkthroughs, particularly in audits of financial statements only.

The intention of including the discussion of walkthroughs was to explain how to perform walkthroughs rather than to impose requirements regarding when walkthroughs should be performed. The standard has been revised to focus on how the auditor should perform walkthroughs, e.g., in connection with understanding the flow of transactions in the information system relevant to financial reporting, evaluating the design of controls relevant to the audit, and determining whether those controls have been implemented.[262/] The discussion of the objectives for understanding likely sources of potential misstatements has been removed from Auditing Standard No. 12, so those objectives would continue to apply only to integrated audits.

(vii). Relationship of Understanding of Internal Control to Tests of Controls

Auditing Standard No. 12, like the reproposed standard, contains a discussion about the relationship between obtaining an understanding of controls and testing controls, including entity-level controls.[263/] The requirements in Auditing Standard No.

[261/] Paragraph 34 of Auditing Standard No. 5.

[262/] Paragraph 37 of Auditing Standard No. 12.

[263/] Paragraph 39 of Auditing Standard No. 12.

12 clarify that the objective of obtaining an understanding of internal control as a risk assessment procedure is different from testing controls for the purpose of assessing control risk[264/] or for the purpose of expressing an opinion on internal control over financial reporting in the audit of internal control.[265/] The standard allows the auditor the flexibility of obtaining an understanding of internal control concurrently with performing tests of controls if he or she obtains sufficient appropriate evidence to achieve the objectives of both procedures.[266/]

f. Information Obtained from Past Audits and Other Engagements

(i). Information from Past Audits

The reproposed standard included a requirement for the auditor to incorporate knowledge obtained during past audits into the auditor's process for identifying risks of material misstatement. One commenter asked for clarification of the meaning of the term "incorporate." Two commenters stated that the most important issue is to determine whether information from past audits is still relevant.

The term "incorporate" is not new and should be familiar to most auditors. For example, it has been used in AU sec. 316 regarding the requirement to incorporate an

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264/ Paragraphs 16-31 of Auditing Standard No. 13.

265/ Paragraph B1 of Auditing Standard No. 5.

266/ Paragraph 39 of Auditing Standard No. 12.

element of unpredictability in the audit in response to fraud risks. The requirement in the reproposed standard was similar to a requirement in Auditing Standard No. 5 to incorporate knowledge obtained during past audits in subsequent year audits of internal control.[267/] Accordingly the term has been retained in Auditing Standard No. 12.

Auditing Standard No. 12 also states that if the auditor plans to limit the nature, timing, or extent of his or her risk assessment procedures by relying on information from past audits, the auditor should evaluate whether the prior-years' information remains relevant and reliable.[268/]

(ii). Information from Other Engagements

The reproposed standard included a requirement for the auditor to take into account relevant information obtained through other engagements performed by the auditor for the company.[269/] This requirement was intended to focus on the responsibility to take relevant information into account in identifying and assessing risks rather than to prescribe a particular method for obtaining that information.

267/ Paragraph 57 of Auditing Standard No. 5.

268/ Paragraph 43 of Auditing Standard No. 12.

269/ PCAOB Rule 1001, Definitions of Terms Employed in Rules, states that, when used in rules of the PCAOB, unless the context otherwise requires, "[t]he term 'auditor' means both public accounting firms registered with the Public Company Accounting Oversight Board and associated persons thereof."

Some commenters suggested that the requirement should be limited to consideration of other engagements performed by the engagement partner. The suggested change would weaken the standard. Limiting the consideration of information to engagements performed for the company by the engagement partner is too narrow because it omits other important information sources that are available to the engagement team. Also, limiting the consideration to engagements performed by the engagement partner is inconsistent with prior PCAOB standards. For example, AU sec. 311.04 stated that procedures the auditor may consider in planning an audit usually involve discussions with other firm personnel, and includes the following example "Discussing matters that may affect the audit with firm personnel responsible for non-audit services to the entity." Also, paragraph 03 of AU sec. 9311, Planning and Supervision: Auditing Interpretations of Section 311, stated:

> The auditor should consider the nature of non-audit services that have been performed. He should assess whether the services involve matters that might be expected to affect the entity's financial statements or the performance of the audit, for example, tax planning or recommendations on a cost accounting system. If the auditor decides that the performance of the non-audit services or the information likely to have been gained from it may have implications for his audit, he should discuss the matter with personnel who rendered the services and consider how the expected conduct and scope of his audit may be affected. In some cases, the auditor

> may find it useful to review the pertinent portions of the work papers prepared for the non-audit engagement as an aid in determining the nature of the services rendered or the possible audit implications.

Other commenters suggested that the requirement be revised to use more of the language from AU sec. 9311. The requirement in Auditing Standard No. 12[270/] has been revised as follows:

> The auditor should obtain an understanding of the nature of the services that have been performed for the company by the auditor or affiliates of the firm[271/] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement.[272/]

One commenter stated that audit firms will need to develop very costly reporting systems to enable them to convey relevant information about nonassurance engagements to audit engagement teams. Existing PCAOB and SEC rules already require firms to track and report nonaudit services provided to the company. Complying with these requirements would mean that the audit firms have a mechanism in place to track these

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270/ Paragraph 45 of Auditing Standard No. 12.

271/ See PCAOB Rule 3501(a)(i), which defines "affiliate of the accounting firm."

272/ Paragraph 7 of Auditing Standard No. 9.

services. For example, PCAOB Rules 3524[273/] and 3526[274/] require the auditor to describe to the company's audit committee, among other things, the scope of and the potential effect on independence of other services provided by the firm. It is expected that the system used to capture, track, and monitor these services for compliance with these PCAOB independence rules would also be applicable to comply with the requirements of Auditing Standard No. 12.

g. Performing Analytical Procedures

The reproposed standard retained requirements from AU sec. 329, Analytical Procedures, to perform analytical procedures during the planning phase of the audit.[275/] Such analytical procedures are, in essence, risk assessment procedures, so the respective requirements and direction have been incorporated into Auditing Standard No. 12.[276/] One commenter stated that it is unclear whether the PCAOB intends a change in practice regarding the execution of analytical procedures performed as risk assessment procedures, e.g., because the requirements in the reproposed standard discussed developing expectations and comparing them to recorded amounts. AU sec. 329, states

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273/ PCAOB Rule 3524, Audit Committee Pre-approval of Certain Tax Services.

274/ PCAOB Rule 3526, Communication With Audit Committees Concerning Independence.

275/ AU secs. 329.06-.08.

276/ Paragraphs 46-48 of Auditing Standard No. 12.

that analytical procedures involve developing expectations and comparing those expectations to recorded amounts.[277/]

Auditing Standard No. 12 states that analytical procedures performed as risk assessment procedures often use data that is preliminary or data that is aggregated at a high level and that in those instances such analytical procedures are not designed with the level of precision necessary for substantive analytical procedures.[278/] In those situations, the auditor's expectations in performing analytical procedures as risk assessment procedures do not require the same degree of precision as substantive analytical procedures.

h. Conducting a Discussion among Engagement Team Members Regarding Risks of Material Misstatement

Like the reproposed standard, Auditing Standard No. 12 includes a requirement that key engagement team members discuss (1) the company's selection and application of accounting principles, including related disclosure requirements and (2) the susceptibility of the company's financial statements to material misstatement due to error or fraud.[279/] The standard explains that key engagement team members include the engagement partner and all engagement team members who have significant engagement

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277/ AU sec. 329.05.

278/ Paragraph 48 of Auditing Standard No. 12.

279/ Paragraph 49 of Auditing Standard No. 12.

responsibilities.[280/] The term "significant engagement responsibilities" should be familiar to auditors because it is already used in AU sec. 316 regarding the appropriate assignment of engagement team members in the overall responses to fraud risks.

One commenter stated that the requirement for participation in the discussion among engagement team members on the reproposed standard should be revised to use the language in ISA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment, so that the engagement partner makes the determination of what needs to be reported to whom on a "need to know" basis.

The language in Auditing Standard No. 12 was retained as reproposed. The Board believes that the discussion among engagement team members is an important part of the auditor's risk assessment procedures. Through its oversight activities, the Board has observed deficiencies relating to discussions among engagement team members regarding fraud risks, including instances in which key engagement team members did not participate.[281/]

(i). Discussion of the Potential for Material Misstatement Due to Fraud

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280/ Paragraph 50 of Auditing Standard No. 12.

281/ PCAOB Release 2007-001, Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud (January 22, 2007).

A number of comments were received regarding the requirements for discussing the risks of material misstatement due to fraud.

One commenter suggested that the standard should require the auditor to consider using a fraud specialist. The Board believes that this point is already covered by the requirement in Auditing Standard No. 9 to evaluate whether a person with specialized skill or knowledge is needed to assess risks.[282/]

One commenter suggested that the requirement to discuss how the financial statements could be materially misstated through omitting or presenting incomplete disclosures also should include the possibility of presenting inaccurate disclosures. The requirement has been revised to include that topic.[283/] Another commenter stated that the standard should provide more "guidance" about how fraud risks relate to disclosures. The manner in which management might intentionally omit disclosures or present inaccurate or incomplete disclosures to commit or conceal intentional misstatement of the financial statements necessarily depends on the circumstances, including the incentives or pressures and the opportunities to manipulate the financial statements. The discussion of fraud risks required by the standard should prompt engagement team members to consider ways in which omissions or inaccuracies in disclosures might be involved with fraudulent financial reporting.

[282/] Paragraphs 16-17 of Auditing Standard No. 12.

[283/] Paragraph 52 of Auditing Standard No. 12.

Another commenter stated that the requirement for the auditor to emphasize certain matters regarding fraud to the engagement team members during the fraud risk discussion does not assign the responsibility to a specific person. The requirement focuses on the communication of important matters rather than on the person communicating the matters. Since the engagement partner has the overall responsibility for the audit engagement, the engagement partner is likely to be the most appropriate person to make the communications. However, Auditing Standard No. 12 allows the communications to be made by another engagement team member, when appropriate.

(ii) Communication Among Engagement Team Members

Auditing Standard No. 12 states that communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change. This requirement carries forward and builds upon a requirement in AU sec. 316.[284/]

i. Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

Like the reproposed standard, Auditing Standard No. 12 requires the auditor to make inquiries of the audit committee, or equivalent (or its chair), management, the internal audit function, and others within the company who might reasonably be expected to have information that is important to the identification and assessment of risks of

[284/] AU sec. 316.18.

material misstatement.[285/] The requirement to inquire of others who "might reasonably be expected to have information" is similar to a requirement in AU sec. 316 for making inquiries of others about the existence or suspicion of fraud, and it establishes a principle to guide the auditor in determining those other persons to whom the inquiries should be addressed.[286/]

(i). Inquiries Regarding Fraud Risks

The reproposed standard also required the auditor to make inquiries of the audit committee (or its chair), management, the internal audit function, and others within the company about the risks of fraud. Commenters suggested that the requirements for identifying other individuals within the company to whom inquiries should be directed should include determining the extent of such inquiries. Auditing Standard No. 12 reflects the suggested revision to that requirement because inquiries of other individuals should be designed to obtain information relevant to identifying and assessing fraud risks.[287/]

The reproposed standard included a requirement to take into account the fact that management is often in the best position to commit fraud when evaluating management's responses to inquiries about fraud risks and determining when it is necessary to

285/ Paragraph 54 of Auditing Standard No. 12.

286/ AU sec. 316.24.

287/ Paragraph 57 of Auditing Standard No. 12.

corroborate management's responses. One commenter stated that the requirement was unclear and the use of the term "take into account" did not seem consistent with the Board's explanation in the release accompanying the reproposed standards. This requirement has been revised to clarify the requirement and to use "take into account" in a manner that is consistent with the other PCAOB standards.[288/]

Auditing Standard No. 12 requires that the auditor use his or her knowledge of the company and its environment, as well as information from other risk assessment procedures, to determine the nature of the inquiries about risks of material misstatement. This requirement carries forward and builds upon a requirement in AU sec. 316.[289/]

Auditing Standard No. 12 includes an additional required inquiry of the internal auditor about whether he or she is aware of instances of management override of controls and the nature and circumstances of such overrides. Also, Auditing Standard No. 12 requires the auditor to make inquiries of management and the audit committee, or equivalent regarding tips or complaints about the company's financial reporting.[290/] These required inquiries were added in light of research indicating that many incidents of fraud

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288/ Paragraph 58 of Auditing Standard No. 12.

289/ AU sec. 316.24.

290/ Paragraph 56 of Auditing Standard No. 12.

are uncovered through tips.[291/] These inquiries can provide important evidence about fraud risks.

Auditing Standard No. 12 requires the auditor, when evaluating management's responses to inquiries about fraud risks and determining when it is necessary to corroborate management's responses, to take into account the fact that management is often in the best position to commit fraud. The standard also requires the auditor to obtain evidence to address inconsistencies in responses to inquiries. This requirement carries forward and builds upon a requirement in AU sec. 316.[292/]

j. Identifying and Assessing the Risks of Material Misstatement

Auditing Standard No. 12 sets forth a process for identifying and assessing the risks of material misstatement using the information obtained from the risk assessment procedures and other relevant knowledge possessed by the auditor.[293/] This process involves:

[291/] See, e.g., Association of Certified Fraud Examiners, 2008 Report to the Nation on Occupational Fraud & Abuse (2008).

[292/] AU sec. 316.27.

[293/] Under Auditing Standard No. 12, the auditor has a responsibility to perform risk assessment procedures that provide an appropriate basis for his or her risk assessment. Auditing Standard No. 12 does not include the provision in the prior interim standards that allowed the auditor to assess risk at the maximum solely for efficiency reasons. Rather, the auditor needs to have a sufficient understanding of the company and its environment, including its internal control, in order to determine the risks of material misstatement and, in turn, to design effective tests of controls and substantive procedures.

- Identifying risks of misstatement using information obtained from risk assessment procedures and considering the characteristics of the accounts and disclosures in the financial statements.

- Evaluating whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions.

- Evaluating the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected. This includes evaluating how risks at the financial statement level could affect risks at the assertion level.

- Assessing the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements. In making this assessment, the auditor may take into account the planned degree of reliance on controls that the auditor plans to test, if the auditor performs tests of controls in accordance with PCAOB standards.

- Identifying significant accounts and disclosures and their relevant assertions.

- Determining whether any of the identified and assessed risks of material misstatement are significant risks.[294/]

One commenter suggested that the word "material" should be inserted before the word "misstatement" in paragraph 56.a. of the reproposed standard. No change was made to Auditing Standard No. 12 because inserting the word "material" would inappropriately narrow the auditor's focus on only material risks too early in the process of identifying and assessing risks of misstatement, i.e., before assessing the likelihood and magnitude of potential misstatements related to the risks.

Commenters suggested that the standard should clarify that the likelihood and magnitude of potential misstatements should be considered in determining which risks are significant risks. Auditing Standard No. 12 includes an additional requirement that states, "To determine whether an identified and assessed risk is a significant risk, the auditor should evaluate whether the risk requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk."[295/] Also, the list of factors that should be evaluated in determining which risks are significant risks was expanded to include "the effect of the quantitative and qualitative risk factors discussed in paragraph 60 of the standard [on identifying significant accounts and disclosures and their relevant assertions] on the likelihood and

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294/ Paragraph 59 of Auditing Standard No. 12.

295/ Paragraph 70 of Auditing Standard No. 12.

potential magnitude of misstatements."[296] Including this new factor highlights the relationship between the identification of significant accounts and disclosures and their relevant assertions and the identification of significant risks. Specifically, risk factors that form the basis for identifying significant accounts and disclosures and their relevant assertions also inform the identification of significant risks, and significant risks affect one or more relevant assertions of significant accounts or disclosures.

Another commenter on the reproposed standard suggested that the term "likelihood" be defined more in terms of reasonable possibility as that term is used in Auditing Standard No. 5. However, that change would be inconsistent with the requirement to assess the likelihood of misstatements, i.e., the possibility that the risk would result in misstatement of the financial statements.

One commenter indicated that the requirement in the note to paragraph 59.c. of the reproposed standard "inappropriately infers that the auditor should, and can, associate the risks at the financial statement level with particular assertions in order to assess risks at the assertion level." Auditing Standard No. 8 states that risks of material misstatement at the financial statement level have a pervasive effect on the financial statements as a whole and potentially affect many assertions, and the standard provides examples of how risks at the financial statement level can result in misstatements.[297] It is important for the

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[296] Paragraph 71 of Auditing Standard No. 12.

[297] Paragraph 6 of Auditing Standard No. 8.

auditor to take into account risks of material misstatement at the financial statement level in order to evaluate types of misstatements that could occur.

Under PCAOB standards, significant accounts and disclosures and their relevant assertions are identified based upon their risk characteristics. Thus, the auditor needs to identify and assess the risks in order to identify the relevant assertions of significant accounts and disclosures in accordance with PCAOB standards. For example, Auditing Standard No. 5 requires the auditor to identify significant accounts and disclosures and their relevant assertions in integrated audits.[298/] Also, AU sec. 319 required the auditor to perform substantive procedures for the relevant assertions of significant accounts and disclosures for all audits of financial statements, which implicitly required the auditor to identify those accounts, disclosures, and assertions.[299/] Auditing Standard No. 12 imposes a more explicit requirement on the auditor to identify significant accounts and disclosures and their relevant assertions in all audits.

(i). Factors Relevant to Identifying Fraud Risks

Auditing Standard No. 12 requires that the auditor evaluate whether the information gathered from the risk assessment procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and

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298/ Paragraph 28 of Auditing Standard No. 5.

299/ Ibid.

assessing fraud risks.[300/] The reproposed standard included a paragraph that stated that the auditor should not assume that all of the fraud risk factors discussed in must be observed to conclude that a fraud risk exists. Commenters suggested that the language was not clear as to the action that auditors would need to take to "not assume." The paragraph has been revised to clarify that all of the conditions are not required to be observed or evident to conclude that a fraud risk exists.[301/]

(ii). Consideration of the Risk of Omitted or Incomplete Disclosures

The reproposed standard stated that the auditor's evaluation of fraud risk factors should include an evaluation of how fraud could be perpetrated or concealed by omitting required disclosures or by presenting incomplete disclosures. One commenter stated that the requirement should also include consideration of the possibility of presenting inaccurate disclosures. Other commenters stated that the requirement should be revised to refer to disclosures required by the applicable financial reporting framework. The requirement has been revised to encompass inaccurate disclosures and to refer to disclosures required for the fair presentation of the financial statements in conformity with the applicable financial reporting framework.[302/]

(iii). Presumption of Fraud Risk Involving Improper Revenue Recognition

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300/ Paragraph 65 of Auditing Standard No. 12.

301/ Paragraph 66 of Auditing Standard No. 12.

302/ Paragraph 67 of Auditing Standard No. 12.

Like the reproposed standard, Auditing Standard No. 12 contains a requirement that the auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.[303/] One commenter recommended rewording this paragraph to state that while revenue recognition should be presumed to be a higher level of risk, there are exceptions. The requirement was retained as stated in the reproposed standard because a significant number of financial reporting frauds relate to revenue recognition.[304/]

k. Definition of Significant Risk

The reproposed standard defined significant risk as a risk of material misstatement that requires special audit consideration. Some commenters stated that the definition of "significant risk" in the reproposed standard should be revised to indicate that significant risks are "identified risks" and that they are determined using the "auditor's judgment" or risks that the auditor "determines." Adding a reference to the auditor's determination or auditor's judgment is unnecessary because those points are inherent in the requirements for identifying significant risks, e.g., in the required evaluation of the likelihood and potential magnitude of misstatements related to the risk. Similarly, the reference to "identified risks" is unnecessary because it is already

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303/ Paragraph 68 of Auditing Standard No. 12.

304/ See, e.g., Committee of Sponsoring Organizations of the Treadway Commission, Fraudulent Financial Reporting: 1998-2007 (May 2010).

mentioned in the requirement for determining significant risks. Accordingly, the definition of significant risk included in the reproposed standard is retained.

8. Auditing Standard No. 13 – The Auditor's Responses to the Risks of Material Misstatement

a. Background

Auditing Standard No. 13 establishes requirements for responding to the risks of material misstatement, including responses regarding the general conduct of the audit and responses involving audit procedures. Auditing Standard No. 13 applies to integrated audits and audits of financial statements only.

b. Linking Assessed Risks and Auditor's Responses

The reproposed standard included a requirement for the auditor to design and implement appropriate responses to the "assessed risks of material misstatement" to address comments received on the original proposed standard for improving the linkage between the auditor's responses and the identification and assessment of risks of material misstatement. Acknowledging the improvements in the reproposed standard, some commenters continued to suggest that the objective also should state that the auditor is to address the assessed risks of material misstatement.

In the Board's view, obtaining sufficient appropriate evidence to support the auditor's opinion requires the auditor to adequately respond to the risks of material misstatement. Accordingly, the title and objective of the standard continue to refer to responding to the risks of material misstatement. However, the Board recognizes that the appropriate identification and assessment of the risks of material misstatement in accordance with Auditing Standard No. 12 enable the auditor to effectively respond to the risks of material misstatement. Auditing Standard No. 13 continues to impose on auditors an unconditional responsibility to design and implement responses that address the risks of material misstatement identified and assessed in accordance with Auditing Standard No. 12.[305/] As with the reproposed standard, noncompliance with the requirements in Auditing Standard No. 12 that leads to a failure to identify or appropriately assess a risk of material misstatement also could result in a failure to appropriately respond to the risk of material misstatement in accordance with this standard.[306/]

c. Overall Responses to Risks

The reproposed standard included a requirement for the auditor to respond to the risks of material misstatement through overall responses and responses involving the nature, timing, and extent of audit procedures. Overall responses relate to the general conduct of the audit, e.g., appropriately assigning and properly supervising engagement team members, incorporating an element of unpredictability into the audit, evaluating the company's selection and application of significant accounting principles, and making

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305/ Paragraph 3 of Auditing Standard No. 13.

306/ Failure to address a risk of material misstatement also might indicate a failure to comply with Auditing Standard No. 12.

pervasive changes to the audit. Such responses are required by AU sec. 316 in response to fraud risks, but the reproposed standard extended the requirement to apply to risks of material misstatement due to error or fraud. These responses, by their nature, are appropriate for addressing risks of material misstatement due to error or fraud.

Some commenters expressed concerns regarding the expansion of the requirement for incorporating an element of unpredictability to apply to risks of material misstatement other than fraud risks.

In the Board's view, although incorporating an element of unpredictability is intended primarily to address fraud risks, it also can enable the auditor to detect errors or control deficiencies that could otherwise remain undetected. In addition, the requirement to incorporate an element of unpredictability when testing controls already exists in Auditing Standard No. 5. Auditing Standard No. 13 continues to indicate that the auditor should incorporate an element of unpredictability as part of the response to the risks of material misstatement, including fraud risks.[307/]

One commenter requested clarification regarding the differences between the first and third examples used to illustrate ways to incorporate an element of unpredictability in paragraph 5.c. of the reproposed standard. The first example in Auditing Standard No. 13 is intended to illustrate that the auditor may decide to perform audit procedures for a particular account, disclosure, or assertion even though the auditor's risk assessment did

[307/] Paragraph 5.c. of Auditing Standard No. 13.

not identify specific risks associated with those accounts.[308/] The third example is intended to illustrate that when sampling a particular financial statement amount, the auditor may consider selecting items with amounts lower than the threshold that the auditor had used in the past, or expanding the selection to other sections of the population that the auditor had not tested in the past.[309/]

The reproposed standard required the auditor to evaluate whether it is necessary to make pervasive changes to the audit to adequately address the assessed risks of material misstatement. The reproposed standard did not require that pervasive changes be made in every audit. Instead, it required the auditor to evaluate whether pervasive changes that affect many aspects of the audit are needed to address the assessed risks of material misstatement. Commenters questioned the use of the term "pervasive" in the requirement. Auditing Standard No. 13 provides additional explanation of the types of circumstances in which pervasive changes might be necessary.[310/]

Existing PCAOB standards require the auditor to apply professional skepticism as part of due care,[311/] and Auditing Standard No. 13 states that the auditor's response to fraud risks involves the application of professional skepticism in gathering and evaluating

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[308/] Paragraph 5.c. (1) of Auditing Standard No. 13.

[309/] Paragraph 5.c. (3) of Auditing Standard No. 13.

[310/] Paragraph 6 of Auditing Standard No. 13.

[311/] AU secs. 230.07-.09.

audit evidence.[312/] The requirement is intended to emphasize the importance of professional skepticism in responding to risks of material misstatement without limiting its application to the auditor's responses.

One commenter expressed concern that the reproposed standard did not explicitly require the auditor to implement overall responses to risks at the financial statement level. Such an explicit requirement would inappropriately limit the auditor's overall responses to risks at the financial statement level. Many of the overall responses also apply to risks at the assertion level, e.g., assigning more experienced personnel or applying a greater extent of supervision to accounts or disclosures with higher risk.

d. Responses Involving the Nature, Timing, and Extent of Audit Procedures

The reproposed standard required the auditor to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure. Auditing Standard No. 13 retained this requirement as reproposed. The requirement emphasizes that the auditor should focus on each relevant assertion of each significant account and disclosure and the risks of material misstatement associated with the relevant assertion when designing and performing audit procedures.

[312/] Paragraph 7 of Auditing Standard No. 13.

The reproposed standard also included requirements for the auditor to design the testing of controls to accomplish the objectives of both the audit of financial statements and the audit of internal control in an integrated audit. This requirement is aligned with Auditing Standard No. 5. One commenter suggested that that the requirement be removed because it relates only to integrated audits. The requirement was retained as reproposed because Auditing Standard No. 13 applies to integrated audits as well as audits of financial statements only, and tests of controls are a necessary response in the audit of internal control.[313/]

e. Tests of Controls in an Audit of Internal Control

Auditing Standard No. 13 includes requirements for performing tests of controls in the audit of financial statements.[314/]

In an integrated audit, the tests of controls performed in the audit of internal control are part of the auditor's responses to the risks of material misstatement, as indicated in paragraph 9-10 of Auditing Standard No. 13.[315/] To help facilitate the integration of tests of controls in an integrated audit, the standard continues to use

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313/ Paragraph 9.c. of Auditing Standard No. 13.

314/ Paragraphs 16-35 of Auditing Standard No. 13.

315/ Paragraph 39 of Auditing Standard No. 5 states, "The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion."

language similar to that of Auditing Standard No. 5 when describing analogous terms and concepts relating to the testing of controls.

f. Tests of Controls and Control Risk Assessment in the Audit of Financial Statements

(i). Requirements on When to Test Controls

AU sec. 319 required auditors to obtain evidence about the design effectiveness and operating effectiveness of controls (a) when the auditor plans to rely on selected controls to reduce his or her substantive procedures and (b) in those limited circumstances in which the auditor cannot obtain sufficient appropriate evidence through substantive procedures alone.[316/] Thus, except in those limited circumstances, AU sec. 319 provided auditors with flexibility to decide when or whether to test controls.

Auditing Standard No. 13 does not change the requirements in AU sec. 319 regarding when testing controls is necessary in audits of financial statements only.[317/] In those audits, auditors continue to have the same flexibility in deciding when or whether to test controls to reduce their substantive procedures.[318/] Auditing Standard No. 13

[316/] AU sec. 319.66.

[317/] Certain clarifying revisions were made to the discussion of relying on controls to modify the auditor's substantive procedures, in response to comments on the reproposed standard. See footnote 12 to paragraph 16 of Auditing Standard No. 13.

[318/] Paragraph 16 of Auditing Standard No. 13.

includes additional statements that emphasize the flexibility that auditors have in making these decisions and provides additional examples, adapted from AU sec. 319.68, of situations in which auditors cannot obtain sufficient appropriate audit evidence through substantive procedures alone.[319/]

(ii). Period of Reliance

Auditing Standard No. 13 states that when the auditor relies on controls to assess control risk at less than the maximum, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance.[320/] The concept of the period of reliance was introduced in Auditing Standard No. 5 and discussed further in the PCAOB staff guidance, Staff Views: An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements – Guidance for Auditors of Smaller Public Companies. Auditing Standard No. 13 provides a definition of "period of reliance" that parallels the language in paragraph B4 of Auditing Standard No. 5.[321/]

319/ Paragraph 17 of Auditing Standard No. 13.

320/ Paragraph 16 of Auditing Standard No. 13.

321/ Paragraph A.3 of Auditing Standard No. 13.

(iii). Evidence about the Effectiveness of Controls

Auditing Standard No. 13 describes the principle, adapted from AU sec. 319,[322/] that the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. In applying that principle, Auditing Standard No. 13 requires the auditor to obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. In addition, Auditing Standard No. 13 requires the auditor to obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.[323/]

(iv). Testing Operating Effectiveness

Auditing Standard No. 13 requires the auditor to determine, among other things, whether the person performing the control possesses the necessary authority and competence to perform the control effectively.[324/] This requirement is intended to call to the auditor's attention that whether he or she possesses the appropriate level of authority and the knowledge and skills necessary to perform the control function is essential to

[322/] AU sec. 319.90.

[323/] Paragraph 18 of Auditing Standard No. 13.

[324/] Paragraph 21 of Auditing Standard No. 13.

whether a person can effectively perform the control. Thus, the auditor is required to make such determination before he or she can conclude about the effectiveness of the control.

(v). Timing of Tests of Controls – Evidence Obtained during an Interim Period

The reproposed standard stated that the auditor must obtain evidence about the effectiveness of controls selected for testing for the entire period of reliance. When the auditor tests controls during an interim period, additional evidence that is necessary concerning the operation of those controls for the remaining period of reliance depends on a series of factors listed in the reproposed standard, including, among other factors, the possibility of significant changes in internal control over financial reporting occurring subsequent to the interim date.

One commenter suggested adding "control environment" to the list of factors that could affect the auditor's determination of what additional evidence is necessary. The control environment has an important, but indirect, effect on the likelihood that a misstatement will be prevented or detected on a timely basis. Also, unlike monitoring controls, the control environment is not designed to identify possible breakdowns in other controls. Accordingly, the control environment, by itself, does not reduce the amount of evidence needed concerning controls over specific relevant assertions for the remaining period. The control environment is not included in the list of factors in Auditing Standard No. 13.

Another commenter suggested adding a requirement for the auditor to obtain, when applicable, audit evidence about subsequent changes to the controls tested during the interim period. A note has been added to Auditing Standard No. 13 requiring the auditor to obtain evidence about such subsequent changes, if significant.[325/]

(vi). Timing of Tests of Controls – Evidence from Past Audits

Auditing Standard No. 13 states that the auditor should obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies.[326/] This requirement is based on the principle that auditors should support their control risk assessments each year with current evidence. However, when the auditor has tested the controls in the past and plans to rely on the same controls for the current year audit, the amount of evidence needed will vary based on the relevant factors listed in the standard.[327/] These additional factors generally relate to the degree of reliance on the control, the risk that the control will fail to operate as designed, and the nature and amount of evidence that the auditor has already obtained regarding the effectiveness of the controls. These requirements are consistent with Auditing Standard No. 5. Also, the standard allows the auditor to use a benchmarking strategy, when appropriate, for automated application controls for subsequent years' audits, as do the

[325/] Paragraph 30 of Auditing Standard No. 13.

[326/] Paragraph 31 of Auditing Standard No. 13.

[327/] Ibid.

provisions of Auditing Standard No. 5. However, the standard does not permit testing controls once every third year because the standard requires evidence regarding the effectiveness of controls to be obtained each year.

Some commenters expressed concern that the requirements in the reproposed standard for determining the amount of evidence needed in the current year could be interpreted as requiring the auditor to consider each factor listed for each of the controls that the auditor tested in the past, regardless of whether or not the auditor plans to rely on those controls for purposes of the current year audit. The requirement was intended to apply when the auditor tested the controls in the past audits and plans to rely on those controls and use evidence about the effectiveness of those controls obtained in prior years for purposes of the current year audit. That requirement is clarified in Auditing Standard No. 13.[328/]

(vii). Assessing Control Risk

Auditing Standard No. 13 requires the auditor to assess control risk for relevant assertions.[329/] This requirement is not new. AU sec. 319 established requirements for the

[328/] Ibid.

[329/] Paragraphs 32-34 of Auditing Standard No. 13.

auditor to assess control risk, and Auditing Standard No. 5 discusses control risk assessment in the financial statement audit portion of the integrated audit.[330/]

Auditing Standard No. 13 requires the auditor to assess the control risk at the maximum level for relevant assertions when the controls necessary to sufficiently address the assessed risk of material misstatement in those assertions are missing or ineffective or when the auditor has not obtained sufficient appropriate evidence to support a control risk assessment below the maximum level.[331/]

One commenter expressed a concern that the reproposed standard seemed to indicate that no reduction of the control risk assessment should occur based on understanding the design effectiveness of controls. The commenter suggested that a control that does not exist or is not designed effectively should have a different impact on the auditor's testing than a control that is designed effectively but not tested by the auditor.

The risk assessment standards already address the points raised by the commenter regarding the effect of control deficiencies on the auditor's testing. Auditing Standard No. 12 requires the auditor to obtain an understanding of the design of the company's controls

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[330/] AU secs. 319.70, .83-.90 and paragraphs B4-B5 of Auditing Standards No. 5.

[331/] Paragraph 33 of Auditing Standard No. 13.

as part of his or her risk assessment procedures.[332/] If the auditor identifies design deficiencies in the company's controls, the auditor would take that into account in identifying and assessing the risks of material misstatement, and Auditing Standard No. 13 requires the auditor to implement responses to address those risks of material misstatement. When deficiencies are detected during the auditor's testing of controls that the auditor plans to rely on, Auditing Standard No. 13 requires the auditor to (1) perform tests of other controls related to the same assertion as the ineffective controls, or (2) revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased assessment of risk.[333/]

Another commenter suggested that the reproposed standard provide more direction about evaluating control deviations by adding a paragraph from Auditing Standard No. 5 regarding evaluating control deficiencies. The referenced paragraph does not apply specifically to assessing control risk in a financial statement audit, and Auditing Standard No. 13 requires the auditor to evaluate the evidence from all sources, including the results of test of controls, when assessing control risk for relevant assertions.[334/]

[332/] Paragraph 20 of Auditing Standard No. 12.

[333/] Paragraph 34 of Auditing Standard No. 13.

[334/] Paragraph 32 of Auditing Standard No. 13.

g. Substantive Procedures

Auditing Standard No. 13 requires the auditor to perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.[335/] By definition, a relevant assertion of a significant account and disclosure has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated.[336/] The requirement to obtain evidence from substantive procedures for each relevant assertion of each significant account and disclosure reflects the principle that the auditors need to implement appropriate responses to address the assessed risks of material misstatement.

Existing PCAOB standards indicate that some risks of material misstatement might require more evidence from substantive procedures because of certain inherent limitations of internal control.[337/] For example, more evidence from substantive procedures ordinarily is needed for relevant assertions that have a higher susceptibility to management override or to lapses in judgment or breakdowns resulting from human failures. Observations from the Board's oversight activities have underscored the importance of this principle. Auditing Standard No. 13 includes this principle because it

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335/ Paragraph 36 of Auditing Standard No. 13.

336/ Paragraph A9 of Auditing Standard No. 5.

337/ See, e.g., paragraph .14 of AU sec. 328, Auditing Fair Value Measurements and Disclosures.

is particularly relevant to the determination of the nature, timing, and extent of substantive procedures. It is also consistent with the principles regarding detection risk discussed in Auditing Standard No. 8.

h. Timing of Substantive Procedures

The reproposed standard included a requirement for the auditor to take into account certain factors in determining whether it is appropriate to perform substantive procedures at an interim date. One commenter suggested that another point be added to the standard to require the auditor to review "the internal control changes that have been made to date and the nature and extent of monitoring such changes by the client staff." Auditing Standard No. 13 requires the auditor to consider the effect of known or expected changes in the company, its environment, and its internal control over financial reporting during the remaining period on its risk assessments when determining whether to perform substantive procedures at an interim date.[338/] This additional requirement recognizes that both changes in controls and other changes to the company and its environment can affect the risks of material misstatement and, thus, the effectiveness of interim substantive procedures. For example, significant changes in industry or market conditions near year end could increase the risk of material misstatement regarding the valuation of assets at year end, which, in turn, would require significant audit attention during the remaining period.

338/ Paragraph 44.a.(3) of Auditing Standard No. 13.

The reproposed standard stated that when an auditor performs substantive procedures as of an interim date, the auditor should perform substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. The reproposed standard also required that the auditor perform certain procedures that were adapted from AU sec. 313.

Some commenters suggested that the Board remove the mandatory procedures in the reproposed standard, arguing that the procedures should be determined by the auditor based on professional judgment. Removing those requirements as suggested by the commenters would weaken PCAOB standards. Observations from the Board's oversight activities have included instances in which inadequate audit work was performed when extending the conclusion reached at the interim date to the end of the period covered by the financial statements. Therefore, retaining the mandatory procedures in this standard continues to be appropriate.[339/]

i. Substantive Procedures Responsive to Significant Risks

Like the original proposed standard, the reproposed standard stated that the auditor should perform substantive procedures, including tests of details, that are

[339/] Paragraph 45 of Auditing Standard No. 13.

specifically responsive to the significant risks. AU sec. 329 indicates that tests of details should be performed in response to significant risks.[340/]

One commenter continued to express concern about imposing a presumptively mandatory responsibility for auditors to perform tests of details in response to significant risks. Auditing Standard No. 13 retains the requirement as reproposed.[341/] The nature and importance of significant risks warrant a high level of assurance from substantive procedures to adequately address the risk. Also, analytical procedures alone are not well suited to detecting certain types of misstatements related to significant risks, including, in particular, fraud risks. For example, when fraud risks are present, management might be able to override controls to allow adjustments that result in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions.

j. Dual-purpose Test

Auditing Standard No. 13 recognized that, in certain situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction, i.e., a dual-purpose test. The auditor is required to design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. In addition, the auditor is required to evaluate the results of the test in forming

340/ AU sec. 329.09.

341/ Paragraph 11 of Auditing Standard No. 13.

conclusions about both the assertion and the effectiveness of the control being tested.[342/] The standard refers the auditors to the relevant requirements in AU sec. 350, Audit Sampling, for determining the proper sample size in a dual-purpose test.

9. Auditing Standard No. 14 – Evaluating Audit Results

a. Background

Auditing Standard No. 14 describes the auditor's responsibilities regarding the process of evaluating the results of the audit and determining whether sufficient appropriate audit evidence has been obtained in order to form the opinion to be expressed in the auditor's report. This standard consolidates into one auditing standard the requirements that were previously included in five separate auditing standards.[343/] The standard highlights matters that are important to the auditor's conclusions about the financial statements and the effectiveness of internal control.

b. Definition of Misstatement

The reproposed standard defined the term "misstatement" as follows:

[342/] Paragraph 47 of Auditing Standard No. 13.

[343/] AU sec. 312, regarding evaluating audit results, including uncorrected misstatements; AU sec. 316, regarding fraud considerations that are relevant to evaluating audit results; AU sec. 329, regarding performing the overall review; AU sec. 326, regarding determining whether sufficient appropriate audit evidence has been obtained; and AU sec. 431, regarding the evaluation of disclosures.

> A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework.[344/] A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework. Misstatements can arise from error (i.e., unintentional misstatement) or fraud.

Some commenters indicated that the definition applied to "material misstatement" rather than "misstatement" and suggested revisions to the definition, e.g., moving the second sentence to the beginning of the definition.

Auditing Standard No. 14 carries forward the definition of "misstatement" as reproposed.[345/] This definition is not a definition of the term "material misstatement." Rather, the definition emphasizes that misstatements prevent financial statements from being fairly presented in conformity with the applicable financial reporting framework, as discussed in AU sec. 411, <u>The Meaning of Present Fairly in Conformity With Generally</u>

[344/] The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

[345/] Paragraph A2 of Appendix A to Auditing Standard No. 14.

Accepted Accounting Principles. The phrase used in the definition, "if material individually or in combination with other misstatements," is equivalent to the phrase "In the absence of materiality considerations," which was used in the description of the term "misstatement" in an auditing interpretation of AU sec. 312.[346/] The second sentence of the definition in Auditing Standard No. 14 describes the most common types of misstatements.[347/]

c. Performing Analytical Procedures in the Overall Review

Auditing Standard No. 14 adapted the requirements that were previously included in AU secs. 316 and 329 to read the financial statements and disclosures and perform analytical procedures in the overall review. The standard imposes on auditors a responsibility to read the financial statements and disclosures and perform analytical procedures to (a) evaluate the auditor's conclusions formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement.[348/] In particular, Auditing Standard No. 14 requires the auditor to evaluate whether (a) evidence gathered in response to unusual or

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[346/] Paragraph .02 of AU sec. 9312, Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312, which is superseded by the risk assessment standards, stated "In the absence of materiality considerations, a misstatement causes the financial statements not to be in conformity with generally accepted accounting principles."

[347/] See also paragraph A2 of Auditing Standard No. 14.

[348/] Paragraph 5 of Auditing Standard No. 14.

unexpected transactions, events, amounts, or relationships previously identified during the audit is sufficient and (b) unusual or unexpected transactions, events, amounts, or relationships indicate risks of material misstatement that were not identified previously.[349/] Performing analytical procedures in the overall review assists the auditor in assessing the conclusions reached and in evaluating the overall financial statement presentation.

Auditing Standard No. 14 adapted a requirement, which previously existed in AU sec. 316, for the auditor to perform analytical procedures relating to revenue through the end of the period.[350/] These procedures are intended to identify unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including a material misstatement due to fraud. Performing analytical procedures relating to revenue is important in light of the generally higher risk of financial statement fraud involving revenue accounts.

Auditing Standard No. 14 requires the auditor to corroborate management's explanations regarding significant unusual or unexpected transactions, events, amounts, or relationships. The standard also states that if management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures to

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349/ Paragraph 6 of Auditing Standard No. 14.

350/ Paragraph 7 of Auditing Standard No. 14.

address the matter.[351/] Auditing Standard No. 15, Audit Evidence, states that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level.[352/] Therefore, obtaining corroboration of management's responses is important in obtaining sufficient appropriate audit evidence.

d. Clearly Trivial

Auditing Standard No. 14 requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial.[353/] Like AU sec. 312, the standard allows the auditor to set a threshold for accumulating misstatements, provided that the threshold is set at a de minimis level that could not result in material misstatement of the financial statements, individually or in combination with other misstatements, after considering the possibility of further undetected misstatement.[354/] The specific limitation on setting a threshold for accumulating misstatements is important to assure a proper evaluation of the effect of uncorrected misstatements on the financial statements.

[351/] Paragraph 8 of Auditing Standard No. 14.

[352/] Paragraph 17 of Auditing Standard No. 15.

[353/] Paragraph 10 of Auditing Standard No. 14.

[354/] Paragraph 11 of Auditing Standard No. 14.

e. Accumulating Misstatements

The reproposed standard required the auditor to accumulate identified misstatements other than those that are clearly trivial. The reproposed standard also required the auditor to use his or her best estimate of the total misstatement in the accounts and disclosures that the auditor has tested, not just the amount of misstatements specifically identified. This includes misstatements related to accounting estimates and projected misstatements from substantive procedures that involve audit sampling.[355/]

Commenters suggested that the standard should use terms such as "known and likely misstatement" or other terms to categorize the misstatements. Auditing Standard No. 14 uses the term "identified misstatement" to refer to misstatements that are identified during the audit and the term "accumulated misstatements" to refer to misstatements that are more than clearly trivial and, thus, should be accumulated by the auditor. Because Auditing Standard No. 14 requires the auditor to use his or her best estimate of the misstatements (which is how AU sec. 312 described "likely misstatements"), it is not necessary to use the term "known and likely misstatements."

f. Correction of Misstatements

Auditing Standard No. 14 requires that if management made corrections to accounts or disclosures in response to misstatements detected by the auditor, the auditor

[355/] Paragraphs 10-12 of Auditing Standard No. 14.

should evaluate management's work to determine whether the corrections have been recorded properly and to determine whether uncorrected misstatements remain.[356/] The standard imposes on auditors a responsibility to determine whether misstatements identified by the auditor and communicated to management are correctly recorded in the accounting records.

g. Considerations When Accumulated Misstatements Approach the Materiality Level or Levels Used in Planning and Performing Audit Procedures

Auditing Standard No. 14 requires the auditor to determine whether the overall strategy needs to be revised when the aggregate of misstatements accumulated during the audit approaches the materiality level or levels used in planning and performing the audit. When the aggregate of misstatements approaches the materiality level or levels used in planning and performing an audit, there likely will be greater than an appropriately low level of risk that possible undetected misstatements, combined with uncorrected misstatements accumulated during the audit, could be material to the financial statements. If the auditor assesses this risk to be unacceptably high, he or she should perform additional audit procedures or determine that management has adjusted the financial statements so that the risk that the financial statements are materially misstated has been reduced to an appropriately low level.[357/]

[356/] Paragraph 16 of Auditing Standard No. 14.

[357/] Paragraph 14 of Auditing Standard No. 14.

The reproposed standard stated that when the aggregate of accumulated misstatements approaches the materiality used in planning and performing the audit, the auditor should perform additional procedures or determine that management has adjusted the financial statements so that the risk of material misstatement has been reduced to an appropriately low level. One commenter suggested that it is not clear what the additional procedures are and that more work is not always the answer. The additional procedures that are necessary depend upon, among other things, the procedures performed by the auditor to date and the nature of the misstatements that were detected.

h. Requirement to Reevaluate the Materiality Level

Auditing Standard No. 11 includes a requirement to reevaluate the established materiality level or levels in certain circumstances. Auditing Standard No. 14 states that if the reevaluation of the materiality level or levels established in accordance with Auditing Standard No. 11 results in a lower amount for the materiality level or levels, the auditor should take into account that lower materiality level in the evaluation of uncorrected misstatements.[358/] The requirements are intended to prevent the auditor from incorrectly concluding that uncorrected misstatements are immaterial because he or she used outdated financial statement information. However, the standard does not allow the auditor to establish a higher level or levels of materiality when uncorrected misstatements exceed the initially established level or levels of materiality.

[358/] Paragraph 17 of Auditing Standard No. 14.

Reevaluating the established materiality level or levels prior to evaluating the effect of uncorrected misstatements will cause audit results to be evaluated based on the latest financial information.

i. Evaluating Uncorrected Misstatements

The reproposed standard stated that the auditor should evaluate the uncorrected misstatements in relation to accounts and disclosures and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors. The reproposed standard retained the provisions regarding qualitative factors that were included in an auditing interpretation to AU sec. 312,[359/] with some minor revisions to align the factors more closely to the terminology in the reproposed standard and to omit qualitative factors that apply only to nonissuers. A commenter indicated that the term "profitability," which is included in the qualitative factors in Appendix B, is not defined, and the commenter suggested including examples of profitability in the reproposed standard. Although this term is not explicitly defined in Auditing Standard No. 14, it should be familiar to auditors because the related auditing interpretation was issued in 2000. Auditing Standard No. 14 carries forward the requirements and the related list of qualitative factors that are substantially the same as those in the auditing interpretation.[360/]

359/ AU secs. 9312.15-.17.

360/ AU sec. 9312 and paragraph 17 and Appendix B of Auditing Standard No. 14.

Auditing Standard No. 14 requires an evaluation of the effects of both uncorrected misstatements detected in prior years and misstatements detected in the current year that relate to prior years.[361] The standard does not address how to evaluate the effects of prior period misstatements because that is an accounting and financial reporting matter. For example, the SEC staff has provided guidance in SEC Staff Accounting Bulletin ("SAB") Topic 1.N, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, on the effects of prior year misstatements when quantifying misstatements in the current year financial statements. This SAB provides the SEC staff's views regarding evaluating the quantitative and qualitative factors regarding the materiality of uncorrected misstatements and evaluating the effects of prior year misstatements.

Auditing Standard No. 14 states that the auditor cannot assume that an instance of error or fraud is an isolated occurrence and that the auditor should evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement.[362] This procedure is important to inform the auditor's conclusions about whether the auditor's risk assessments remain appropriate and whether he or she has obtained sufficient appropriate evidence to support his or her opinion.

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[361] Paragraph 18 of Auditing Standard No. 14.

[362] Paragraph 19 of Auditing Standard No. 14.

The reproposed standard included a requirement to evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement. A commenter suggested that this evaluation should be performed at the time the misstatement is identified. In the Board's view, it is not necessary to prescribe the timing for the evaluation of the nature and effects of misstatements on the risk assessments. However, performing this evaluation during the course of the audit could allow the auditor to make the necessary modifications to his or her planned audit procedures on a more timely basis.

The reproposed standard required the auditor to evaluate whether identified misstatements might be indicative of fraud and, in turn, how they affect the auditor's evaluation of materiality and the related audit responses. This requirement is adapted from AU sec. 316.[363/] One commenter suggested that when there is an indicator of fraud, the requirement should make clear that clearly trivial misstatements may need to be evaluated to determine if they should be included in the accumulated misstatements. Like AU sec. 316, the requirement in the reproposed standard was phrased in terms of identified misstatements rather than accumulated misstatements because fraud of relatively small amounts can be material to the financial statements.

[363/] AU sec. 316.75.

Auditing Standard No. 14 retains the requirement as reproposed.[364/] If an auditor detects a misstatement, he or she should evaluate whether the misstatement is indicative of fraud when deciding whether a misstatement is clearly trivial and thus does not warrant being included with accumulated misstatements. Additionally, in situations in which the auditor believes that a misstatement is or might be intentional and the effect on the financial statements could be material or cannot be readily determined, Auditing Standard No. 14 requires that the auditor perform procedures to obtain additional audit evidence to determine whether the fraud has occurred or is likely to have occurred. If the fraud has occurred or is likely to have occurred, the auditor is required to determine its effect on the financial statements and the auditor's report thereon.

j. Communication of Accumulated Misstatements to Management

The reproposed standard required the auditor to communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them. The reproposed standard also required the auditor to obtain an understanding of the reasons that management decided not to correct misstatements communicated by the auditor.

Some commenters suggested that the standard should specifically require the auditor to request management to correct the misstatements.

[364/] Paragraph 20 of Auditing Standard No. 14.

Auditing Standard No. 14 retains the requirement as reproposed.[365/] It is not necessary to specifically require the auditor to request that management correct the misstatements because management has its own legal responsibilities in relation to the preparation and maintenance of the company's books, records, and financial statements. Section 13(i) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78m(i), requires the financial statements filed with the SEC to reflect all material correcting adjustments identified by the auditor.

k. Communication of Illegal Acts

Auditing Standard No. 14 requires the auditor to determine his or her responsibility under AU secs. 316.79-.82A, AU sec. 317, and Section 10A of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j-1, if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred.[366/]

l. Evaluating the Qualitative Aspects of the Company's Accounting Practices

Auditing Standard No. 14 requires the auditor to evaluate the qualitative aspects of the company's accounting practices, including potential bias in management's

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[365/] Paragraphs 15 and 25 of Auditing Standard No. 14.

[366/] Paragraph 23 of Auditing Standard No. 14.

judgments regarding the amounts and disclosures in the financial statements.[367/]

Auditing Standard No. 14 also states that if the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. Also, the standard states that the auditor should evaluate whether the auditor's risk assessments, including, in particular, the assessment of fraud risks, and the related audit responses remain appropriate.[368/]

The reproposed standard included an example of management bias, which was based on observations from the Board's oversight activities. This example indicated that when management identifies adjusting entries that offset misstatements identified by the auditor, the auditor should perform procedures to determine why the underlying misstatement was not identified previously. The auditor also should evaluate the implications on the integrity of management, and the auditor's risk assessments, including fraud risk assessments, and perform additional procedures as necessary to address the risk of further undetected misstatements. A commenter suggested using the phrase "identified misstatements other than those that are … clearly trivial" instead of "identified

[367/] Paragraph 24 of Auditing Standard No. 14.

[368/] Paragraph 26 of Auditing Standard No. 14.

misstatements." The requirement has been revised to refer to misstatements accumulated by the auditor as required by paragraph 10 of Auditing Standard No. 14.[369/]

m. Assessment of Fraud Risks

The reproposed standard required the auditor to evaluate whether the accumulated results of auditing procedures and other observations affect the auditor's assessment of fraud risks made throughout the audit and whether the audit procedures need to be modified to respond to those risks.[370/] The reproposed standard included a reference to Appendix C, which listed matters that might affect the assessment of fraud risks. Appendix C stated that if the matters listed in the appendix are identified during the audit, the auditor should determine whether the assessment of fraud risks remains appropriate or needs to be revised. This requirement was included because the evaluation provides additional insight regarding the fraud risks and the potential need to perform additional procedures to support the opinion to be expressed in the auditor's report.

Some commenters indicated that the requirement in Appendix C seems to indicate that the auditor is required to determine if each item identified during the audit individually affects the assessment of fraud risks, which appears to be inconsistent with paragraph 28. Those commenters suggested revisions to the first sentence of Appendix C. After considering these comments, the first sentence of Appendix C has been revised to

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369/ Paragraph 25 of Auditing Standard No. 14.

370/ Paragraph 28 of Auditing Standard No. 14.

state that if the matters listed in the appendix are identified during the audit, the auditor should take into account these matters in the evaluation of the assessment of fraud risks, as discussed in paragraph 28.[371/]

One commenter suggested including in Appendix C specific procedures that the auditor could perform to evaluate fraud risk, such as evaluating journal entries with round numbers or amounts slightly below a specified threshold. This type of procedure could be appropriate for selecting journal entries for testing, but it is different in nature from the matters listed in Appendix C.

Auditing Standard No. 14 includes a requirement for the engagement partner to determine whether there has been appropriate communication with the other engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks.[372/] This requirement is adapted from the existing PCAOB standards.[373/]

n. Evaluating Financial Statement Disclosures

The reproposed standard included a requirement, adapted from AU sec. 431, for the auditor to evaluate whether the financial statements contain the required disclosures

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[371/] Paragraph C1 of Appendix C to Auditing Standard No. 14.

[372/] Paragraph 29 of Auditing Standard No. 14.

[373/] AU sec. 316.18.

and, if the required disclosures are not included in the financial statements, to express a qualified or adverse opinion in accordance with AU sec. 508, Reports on Audited Financial Statements. The reproposed standard also stated that evaluation of disclosures includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth. These requirements were included in the reproposed standard because of the importance of disclosures to the fair presentation of financial statements.

Some commenters stated that the requirements regarding evaluation of disclosures should be qualified based on materiality considerations. Auditing Standard No. 14 states that the auditor should evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework, which is aligned with an analogous requirement in AU sec. 508.41.[374/] AU sec. 411 discusses the concept of materiality regarding the auditor's opinion that financial statements are presented fairly.[375/]

Another commenter questioned whether the statement that "Evaluation of disclosures includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the

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[374/] Paragraph 31 of Auditing Standard No. 14.

[375/] AU sec. 411.04.

terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth" is a requirement. The statement in the reproposed standard, which is retained in Auditing Standard No. 14, explains that the scope of the auditor's required evaluation of the information disclosed in the financial statements includes matters such as the form, arrangement, and content of the financial statements.[376/]

o. Evaluating the Sufficiency and Appropriateness of Audit Evidence

The reproposed standard required the auditor to conclude on whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements. The reproposed standard also presented a list of factors that are relevant to the auditor's conclusion on whether sufficient appropriate audit evidence has been obtained. Consideration of the listed factors is essential to reaching an informed conclusion about whether sufficient appropriate audit evidence has been obtained. Accordingly, both the requirement and the list of factors contained in the reproposed standard have been retained.[377/]

A commenter suggested that corrected adjustments also should be considered in concluding whether sufficient appropriate audit evidence has been obtained. Auditing Standard No. 14 already requires the auditor to evaluate the results of audit procedures in

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376/ Paragraph 31 of Auditing Standard No. 14.

377/ Paragraphs 33-34 of Auditing Standard No. 14.

evaluating whether sufficient appropriate evidence has been obtained, and this would include misstatements identified by the auditor, regardless of whether they were corrected by management.[378/]

The reproposed standard expanded the requirements regarding situations in which the auditor has not obtained sufficient appropriate audit evidence to include situations in which the auditor has substantial doubt about a relevant assertion. This additional provision was adapted from AU sec. 326. A commenter suggested that the requirement be revised to state that the auditor should attempt to obtain additional evidence if the auditor has not obtained sufficient appropriate evidence about a relevant assertion. The requirement has been retained as stated in the reproposed standard because it covers situations in which the evidence is inadequate and situations in which the auditor has concerns about whether an assertion is misstated.[379/]

p. Evaluating the Results of the Audit of Internal Control

The reproposed standard included a section relating to evaluating audit results in the audit of internal control, which references Auditing Standard No. 5 for the requirements on evaluating the results of the audit of internal control.[380/] A commenter suggested removing this paragraph from the reproposed standard. Auditing Standard No.

378/ Paragraph 34 of Auditing Standard No. 14.

379/ Paragraph 35 of Auditing Standard No. 14.

380/ Paragraph 37 of Auditing Standard No. 14.

14 retains this paragraph, although it does not impose additional requirements. Including this paragraph emphasizes that, in integrated audits, the evaluation of audit results is an integrated process that affects both audits.

10. Auditing Standard No. 15 – Audit Evidence

a. Background

Auditing Standard No. 15 explains what constitutes audit evidence, establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence to support the opinion in the auditor's report, and discusses methods for selecting items for testing.

b. Nature of Audit Evidence

The reproposed standard stated that audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and any information that contradicts such assertions.

One commenter indicated that the meaning of the phrase "and any information that contradicts such assertions" was unclear. The commenter suggested that the Board clarify whether the requirement meant the auditor should look for such contradictory information, or if the requirement should apply only when such information comes to the auditor's attention.

PCAOB standards require the auditor to plan and perform the audit to obtain sufficient appropriate evidence to support an opinion about whether the financial statements are free of material misstatement and, in the audit of internal control, whether material weaknesses exist.[381/] Thus, the auditor is required to perform the audit procedures necessary to test the accounts and controls, regardless of whether the results of those procedures support or contradict the assertions. The requirement in Auditing Standard No. 15 means that when contradictory evidence is obtained, the auditor should evaluate it when forming a conclusion on the financial statements and, in integrated audits, on internal control over financial reporting. To clarify the requirement, Auditing Standard No. 15 omits the word "any."[382/]

c. Objective

The objective in the reproposed standard acknowledged the auditor's responsibility to plan and perform the audit to obtain sufficient appropriate audit evidence to support the opinion expressed in the auditor's report. Commenters suggested revising the wording in paragraph 4 of the reproposed standard to be consistent with the objective

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[381/] Paragraph 3 of Auditing Standard No. 8 and paragraph 3 of Auditing Standard No. 5, respectively.

[382/] Paragraph 2 of Auditing Standard No. 15.

in paragraph 3 of the reproposed standard. The requirement in paragraph 4 of Auditing Standard No. 15 has been revised to be consistent with the objective of the standard.

d. Sufficient Appropriate Audit Evidence

The reproposed standard explained the meaning of the words "sufficient" and "appropriate" as used in the phrase "sufficient appropriate audit evidence." Commenters suggested that the Board provide formal definitions for terms like "sufficiency" and "appropriate" so the terms can be easily located within the standards. Adding definitions is unnecessary because Auditing Standard No. 15 already describes the terms "sufficiency" and "appropriateness" and explains the relevant characteristics of each.[383/]

Commenters stated that the term "persuasive" was used in the reproposed standard, The Auditor's Responses to the Risks of Material Misstatement, and recommended that the Board clarify in the reproposed audit evidence standard the manner in which the persuasiveness of evidence affects the evaluation of audit evidence. The concept of "persuasiveness of evidence" is discussed in Auditing Standard No. 13.[384/]

e. Relevance and Reliability

The reproposed standard contained a discussion about the relevance and reliability of audit evidence. The reproposed standard stated that the audit evidence must be both

[383/] Paragraphs 5-6 of Auditing Standard No. 15.

[384/] Paragraph 39 of Auditing Standard No. 13.

relevant and reliable to support the auditor's conclusions about the subject of the audit procedure. The reproposed standard stated that "[e]vidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized, or otherwise converted into electronic form, the reliability of which depends on the controls over the conversion and maintenance of those documents."

One commenter suggested that the standard be revised to indicate that electronic information, subject to proper controls, is in many ways more reliable than physical documentation. The language from the reproposed standard was retained in Auditing Standard No. 15.[385/] Although evidence sometimes is available only in electronic form and the reliability of electronic evidence depends on the controls over that information, an authentic original document generally is more reliable than an electronic form of that document.

The reproposed standard stated that the relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The relevance of audit evidence depends on (a) the design of the audit procedure used to test the assertion or control, and (b) the timing of the audit procedure used to test the assertion or control. One commenter recommended the description of the term "relevance" should be expanded to include the following statements:

[385/] Paragraph 8 of Auditing Standard No. 15.

Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, when appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing.

Auditing Standard No. 15 retains the description included in the reproposed standard because it is clearer than the suggested revision.[386/]

The reproposed standard indicated that "[t]he auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should evaluate the effect, if any, on the other aspects of the audit."

One commenter suggested that the requirement for the auditor to modify the planned audit procedures or perform additional audit procedures in response to concerns about the authenticity of documents should be linked to professional skepticism. The commenter also stated that many modifications are routine. The requirement was not meant to require the auditor to perform unlimited procedures but, rather, to perform the procedures necessary to address the issue in the circumstances. Auditing Standard No. 15

386/ Paragraph 7 of Auditing Standard No. 15.

retains this requirement as reproposed.[387/] Although professional skepticism is important in these situations, it is not the only factor that determines the procedures necessary to address the matter.

f. Financial Statement Assertions

In representing that the financial statements are presented fairly in conformity with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of financial statements and related disclosures. Financial statement assertions are an important consideration for audits performed in accordance with PCAOB standards. For example, AU sec. 319 required auditors to perform substantive procedures for relevant assertions in audits of financial statements. Auditing Standard No. 5 requires auditors to obtain evidence about the design and operating effectiveness of controls over relevant assertions in audits of internal control.

The reproposed standard retained the five categories of financial statement assertions in AU sec. 326 and Auditing Standard No. 5. Two commenters suggested that the Board use different descriptions for financial statement assertions. One commenter suggested using other standard-setters' descriptions of financial statement assertions. The other commenter suggested using a different description of assertions. Auditing Standard

[387/] Paragraph 9 of Auditing Standard No. 15.

No. 15 retains the categories of assertions as reproposed.[388/] Like Auditing Standard No. 5,[389/] Auditing Standard No. 15 allows auditors the flexibility to use categories of assertions that differ from the assertions listed in the standard under specified conditions.[390/]

g. Inquiry

The reproposed standard stated that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control. One commenter suggested that the note to paragraph 17 of the reproposed standard be revised to include "design and operating effectiveness of a control" and that the auditor should perform audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Auditing Standard No. 15 retains the language from the reproposed standard. The phrase "effectiveness of a control" encompasses both design and operating effectiveness. It is not considered necessary to add that the auditor should perform additional procedures, since Auditing Standard No. 15 states that inquiry, by itself, does not provide sufficient audit evidence.[391/]

388/ Paragraph 11 of Auditing Standard No. 15.

389/ See the note to paragraph 28 of Auditing Standard No. 5.

390/ Paragraph 12 of Auditing Standard No. 15.

391/ Paragraph 17 of Auditing Standard No. 15.

h. Confirmation

The reproposed standard stated that a confirmation represents audit evidence obtained by the auditor as a direct response to the auditor from a third party. Some commenters suggested that the reproposed standard clarify that a confirmation be written. Auditing Standard No. 15 has been revised to state that a confirmation response represents a particular form of audit evidence obtained by the auditor from a third party in accordance with PCAOB standards.[392/] The Board has a separate standards-setting project on confirmations that, among other things, will address the use of written confirmation or other alternative forms of confirmation.[393/]

i. Analytical Procedures

The reproposed standard described analytical procedures as an audit procedure for obtaining evidence. One commenter suggested adding "scanning" as part of analytical procedures. Scanning is a means for selecting items for testing, not a separate audit procedure. The description of analytical procedures in Auditing Standard No. 15 is retained as reproposed.[394/]

392/ Paragraph 18 of Auditing Standard No. 15.

393/ PCAOB Release No. 2010-003, Proposed Auditing Standard Related to Confirmation and Related Amendments to PCAOB Standards (July 13, 2010).

394/ Paragraph 21 of Auditing Standard No. 15.

j. Selecting Items for Testing to Obtain Audit Evidence

Auditing Standard No. 15 contains a section on selecting items for testing that is adapted from an auditing interpretation of AU sec. 350.[395/] The standard also states that the auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure.[396/]

The reproposed standard defined audit sampling as the application of an audit procedure to less than 100 percent of the occurrences of a control or items comprising an account for the purpose of evaluating some characteristic of the control or account. One commenter stated that the definition in the standard should be conformed to AU sec. 350. Auditing Standard No. 15 reflects revisions that align the standard with AU sec. 350.

k. Other Changes

As noted in the reproposing release, certain topics that were included in AU sec. 326 were not carried forward to the reproposed standard and Auditing Standard No. 15. AU sec. 326 discussed the use of audit objectives, and an appendix to that standard illustrated how auditors might use assertions to develop audit objectives and substantive tests of inventory. Such a discussion is not necessary because the auditing standards do

395/ AU sec. 9350, Audit Sampling: Auditing Interpretations of AU sec. 350.

396/ Paragraph 22 of Auditing Standard No. 15.

not require auditors to establish audit objectives to link assertions to substantive procedures. However, omission of this discussion would not preclude auditors from using audit objectives in designing their audit procedures.

11. Amendments to PCAOB Standards

a. Amendments to Auditing Standard No. 3

In the release accompanying the original proposed standards, the Board sought comment on the need for specific documentation requirements regarding the risk assessment procedures. Responses from commenters were mixed. Some commenters supported adding specific documentation requirements, other commenters stated that the requirements in Auditing Standard No. 3, Audit Documentation, were adequate, and one commenter was ambivalent.

After consideration of these comments and additional analysis, the amendments accompanying the reproposed standards included certain amendments to Auditing Standard No. 3 to (a) specify certain required documentation regarding the auditor's risk assessments and related responses, (b) align certain terms and provisions of Auditing Standard No. 3 with the risk assessment standards, and (c) incorporate the principles for documentation of disagreements among engagement team members. For example, the amendments indicated that the auditor's documentation should include the following:

- A summary of the identified risks of misstatement and the auditor's assessment of risks of material misstatement at the financial statement and assertion levels; and

- The auditor's responses to the risks of material misstatement, including linkage of the responses to those risks.

Also, the requirements regarding documentation of significant findings or issues and related matters were expanded to require documentation regarding the significant risks identified and the results of the auditing procedures performed in response to those risks.

A commenter indicated that the additional documentation requirement will result in "unnecessary linkage" and "a matrix-like mentality" to the audit documentation. The documentation requirements are intended to enhance the auditor's ability to link identified and assessed risks to appropriate responses and could help reviewers understand the areas of greatest risk and the auditor's responses to those risks. In addition to these documentation requirements, the auditor would continue to be responsible for preparing documentation as required by other provisions of Auditing Standard No. 3, e.g., to demonstrate that the engagement complied with the standards of the PCAOB.[397/]

[397/] Paragraph 5.a. of Auditing Standard No. 3.

Some commenters suggested placing the documentation requirements in the respective risk assessment standards rather than amending Auditing Standard No. 3. The risk assessment standards are foundational standards; therefore, the required documentation related to the risk assessment standards is included in Auditing Standard No. 3.[398/] Future decisions about the placement of new documentation requirements will be made during the course of the respective standards-setting projects.

b. Amendments to Auditing Standard No. 4

The amendment to Auditing Standard No. 4, Reporting on Whether a Previously Reported Material Weakness Continues to Exist, is limited to changing the word "competent" to "appropriate" when that word is used in reference to audit evidence.

c. Amendments to Auditing Standard No. 5

The amendments to Auditing Standard No. 5 that accompanied the reproposed standards were limited to changing the phrase "any assistants" to "the members of the engagement team," changing the word "competent" to "appropriate" when that word is used in reference to audit evidence, and updating references to auditing standards that are being superseded or amended. These amendments are retained as reproposed.

One commenter suggested a series of additional amendments to Auditing Standard No. 5, which primarily involved removing certain paragraphs from Auditing

[398/] Paragraphs 9, 12, and 19 of Auditing Standard No. 3, as amended.

Standard No. 5 that relate to risk assessment procedures or other requirements that are included in the risk assessment standards. The Board is not removing the requirements regarding risk assessment procedures from Auditing Standard No. 5 because those requirements are important to understanding the other provisions of Auditing Standard No. 5 for performing an audit of internal control.

d. Amendments to Auditing Standard No. 6

The amendments to Auditing Standard No. 6, Evaluating Consistency of Financial Statements, are limited to removing a footnote stating that the term "error" as used in Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections ("SFAS No. 154"), is equivalent to "misstatement" as used in the auditing standards and updating a reference to a standard that is being superseded. This technical change is made because the footnote regarding misstatements in Auditing Standard No. 6 refers to SFAS No. 154, whereas the definition of "misstatement" in Auditing Standard No. 14 on evaluating audit results is neutral regarding the financial reporting framework. However, this technical change does not alter the fact that an error under accounting standards generally accepted in the United States is a misstatement under Auditing Standard No. 14.

e. Amendments to Auditing Standard No. 7

The amendments to Auditing Standard No. 7, Engagement Quality Review, update footnote 3 and the note to paragraph 10 to replace a reference to an interim standard that is superseded and to update the definitions of the terms "engagement partner" and "significant risk" to conform to the definitions in the risk assessment standards.

f. Amendments to Interim Auditing Standards

(i). Superseded Sections

The risk assessment standards supersede the following sections of PCAOB interim auditing standards:

- AU sec. 311, Planning and Supervision
- AU sec. 312, Audit Risk and Materiality in Conducting an Audit
- AU sec. 313, Substantive Tests Prior to the Balance Sheet Date
- AU sec. 319, Consideration of Internal Control in a Financial Statement Audit
- AU sec. 326, Evidential Matter
- AU sec. 431, Adequacy of Disclosure in Financial Statements

Similarly, the auditing interpretations of AU secs. 311, 312, and 350 have been incorporated into the risk assessment standards and thus are superseded. The auditing interpretations of AU sec. 326, except for Interpretation No. 2 (AU secs. 9326.06-.23), also are superseded.[399/]

(ii). AU sec. 316, Consideration of Fraud in a Financial Statement Audit

The relevant requirements regarding identifying and assessing fraud risks, principally AU secs. 316.14-.45; responding to fraud risks, principally AU secs. 316.46-.50; and evaluating audit results, principally AU secs. 316.68-.78, have been incorporated into Auditing Standard Nos. 12, 13, and 14, respectively. The remaining portions of AU sec. 316 describe important principles regarding the auditor's responsibility with respect to fraud and more detailed requirements regarding the auditor's responses to fraud risks. Topics covered in the remaining portions of AU sec. 316, as amended, include the following:

- A description of fraud and its characteristics,
- The importance of exercising professional skepticism,
- Examples of fraud risk factors,

[399/] Interpretation No. 2 relates in part to AU sec. 336 and AU sec. 337, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments, and it will be evaluated in connection with standards-setting projects related to those standards.

- Examples of audit procedures performed to respond to fraud risks involving fraudulent financial reporting and misappropriation of assets, and

- Requirements regarding procedures to further address the risk of material misstatement due to fraud involving management override of controls, including examining journal entries and other adjustments for evidence of possible material misstatement due to fraud; reviewing accounting estimates for biases that could result in material misstatement due to fraud; and evaluating the business rationale for significant unusual transactions.

<u>(iii).</u> <u>AU sec. 329, Analytical Procedures</u>

The discussion in AU sec. 329 regarding analytical procedures performed during audit planning, principally AU secs. 329.03 and 329.06-.08, is incorporated into Auditing Standard No. 12. Similarly, the requirements regarding analytical procedures in the overall review, principally AU secs. 329.23-.24, are incorporated into Auditing Standard No. 14. The remaining portion of AU sec. 329 relates to analytical procedures performed as substantive procedures. Therefore, AU sec. 329 is retitled, <u>Substantive Analytical Procedures</u>, which more accurately reflects the content of the amended standard.

A standard that focuses solely on substantive analytical procedures highlights more clearly the requirements that apply to analytical procedures performed for that purpose, including, the higher degree of precision in substantive analytical procedures needed to provide the necessary level of assurance. The Board has observed instances in which auditors performed substantive procedures to test accounts without meeting the requirements in AU sec. 329 for substantive analytical procedures.[400/]

(iv). AU sec. 336, Using the Work of a Specialist

The text of footnote 1 to paragraph .01 and of paragraph .05 were amended to clarify that AU sec. 336 does not apply to situations in which persons who participate in the audit have specialized skills or knowledge in accounting or auditing (e.g., IT specialists and income tax specialists) and to specialists employed by the firm. Auditing Standard No. 10 applies to those situations. Those clarifications were previously included in the reproposed standard on audit planning and supervision.

(v). AU sec. 350, Audit Sampling

The discussion in AU sec. 350 regarding audit risk and tolerable misstatement has been amended to align more closely with the terminology used in the risk assessment standards.

The reproposed standards included amendments to AU secs. 350.23 and 350.38, which explained more specifically the principles in the standard for determining sample sizes when nonstatistical sampling approaches are used. Some commenters expressed

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[400/] See, e.g., PCAOB Release 2007-010, Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms (October 22, 2007).

concern that the reproposed amendments would have required auditors who use nonstatistical sampling methods to compute sample sizes under both statistical and nonstatistical methods to demonstrate that the sample size under the nonstatistical method equaled or exceeded the sample size determined using a statistical method.

Commenters suggested that the standard should state that it is not necessary to compute sample sizes using statistical methods. Including such a sentence in the standard might be misunderstood by auditors and weaken the requirement of the amended standard. The reproposed amendments do not require auditors to compute sample sizes using statistical methods in all instances to demonstrate compliance with the requirements. For example, the use of a nonstatistical sampling methodology that is adapted appropriately from a statistical sampling method also could demonstrate compliance. However, calculating a sample size that is not based on the relevant factors in AU sec. 350 is not in compliance with the standard. Accordingly, the amendments are retained as reproposed.

(vi). AU sec. 543, Part of Audit Performed by Other Independent Auditors, and interpretations

A note was added to paragraph .01 to clarify that Auditing Standard No. 10 applies to situations not covered by AU sec. 543 in which the auditor engages other accounting firms or other accountants to participate in the audit. Paragraph .12 was amended to align AU sec. 543 with related amendments to Auditing Standard No. 3.

Footnote 4 to paragraph .16 of AU sec. 9543, Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543, is deleted because it refers to an interim standard that is being superseded.

(vii). Other Amendments to the Interim Auditing Standards

For the following interim auditing standards, the amendments are limited to conforming terminology to the risk assessment standards and updating references to auditing standards that are being superseded or amended:

- AU sec. 110, Responsibilities and Functions of the Independent Auditor
- AU sec. 150, Generally Accepted Auditing Standards
- AU sec. 210, Training and Proficiency of the Independent Auditor
- AU sec. 230, Due Professional Care in the Performance of Work
- AU sec. 310, Appointment of the Independent Auditor
- AU sec. 315, Communications Between Predecessor and Successor Auditors
- AU sec. 317, Illegal Acts by Clients
- AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.

- AU sec. 324, Service Organizations
- AU sec. 328, Auditing Fair Value Measurements and Disclosures
- AU sec. 330, The Confirmation Process
- AU sec. 332, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities
- AU sec. 333, Management Representations
- AU sec. 334, Related Parties, and AU sec. 9334, Related Parties: Auditing Interpretations of Section 334
- AU sec. 9336, Using the Work of a Specialist: Auditing Interpretations of Section 336
- AU sec. 341, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern
- AU sec. 342, Auditing Accounting Estimates, and AU sec. 9342, Auditing Accounting Estimates: Auditing Interpretations of Section 342
- AU sec. 380, Communication With Audit Committees
- AU sec. 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles

- AU sec. 508, Reports on Audited Financial Statements, and AU sec. 9508, Reports on Audited Financial Statements: Auditing Interpretations of Section 508

- AU sec. 530, Dating of the Independent Auditor's Report

- AU sec. 722, Interim Financial Information

g. Amendments to Interim Ethics Standards

In the interim ethics standards, ET sec. 102, Integrity and Objectivity, the amendments are limited to updating references to auditing standards that are being superseded or amended.

12. Effective Date

In its reproposal of the proposed rules, the Board stated that it expects the standards would be effective for audits of fiscal years beginning on or after December 15, 2010, subject to approval by the Commission, and the Board requested comment on the proposed effective date. Several commenters stated that the Board should establish sufficient time for auditing firms to make changes to their methodologies and train their staff on the new risk assessment standards.

After considering the comments received and the timing of the adoption of the standards, the Board has determined that the accompanying standards and related amendments will be effective, subject to Commission approval, for audits of fiscal periods beginning on or after December 15, 2010. In its determination, the Board considered that many auditors already employ risk-based audit methodologies, which should facilitate the methodology changes and training necessary to implement the standards by the effective date.

13. Other Topics Not Related to the Reproposed Standards

The comment letters on the reproposed standards included certain comments that relate to standards-setting matters other than the reproposed standards. The following paragraphs discuss those comments.

a. Standards-setting Process

Some commenters suggested changes to the Board's standards-setting process. These comments primarily relate to the extent to which the Board uses the standards of the IAASB and ASB in its standards-setting and the use of external task forces in drafting standards.

In previous releases on its proposed risk assessment standards, the Board has stated that it has sought to eliminate unnecessary differences with the risk assessment standards and those of other standards-setters. However, because the Board's standards must be consistent with the Board's statutory mandate,[401/] differences will continue to exist between the Board's standards and the standards of the IAASB and ASB e.g., when

[401/] E.g., Section 101 of the Sarbanes-Oxley Act of 2002 (the "Act"), 15 U.S.C. § 7211.

the Board decides to retain an existing requirement in PCAOB standards that is not included in IAASB or ASB standards. Also, certain differences are often necessary for the Board's standards to be consistent with relevant provisions of the federal securities laws or other existing standards or rules of the Board. Also, the Board's standards-setting activities are informed by and developed to some degree, in response to observations from its oversight activities.

The Board has a number of means available to seek additional comments from external parties regarding its standards-setting activities, including meetings with its Standing Advisory Group ("SAG"), issuing concept releases or reproposing standards or rules, and conducting public roundtables. Although these are not the only means available to the Board, they have been used because they offer the Board the ability to obtain comments from a diverse group of interested parties through a public process.

The Board continually endeavors to improve its processes, including its standards-setting process, and considers comments from the public as it does so. For example, the Board has undertaken certain steps to enhance the transparency of its standards-setting process, including maintaining on its Web site its standards-setting agenda and discussing the status of projects in public meetings with the SAG. This release has also been expanded to provide additional discussion of and explanation for the Board's conclusions regarding the risk assessment standards. Some commenters acknowledged the Board's efforts to increase the transparency of its process.

b. Other Standards-setting Projects

Commenters on the reproposed standards also recommended a number of additional standards-setting or standards-related projects for the Board. Examples of such projects included creating a codification of the Board's standards; creating a glossary of terms used in the Board's standards, issuing a concept release for the review of the Board's interim standards, developing a standard describing the overall objectives of the audit, similar to ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing, and developing guidance related to how the Board would evaluate the reasonableness of judgments based on PCAOB auditing standards.

The Board continually assesses its standards-setting and related projects based upon the need for improvements in standards or additional guidance in response to current developments, observations from the Board's oversight activities, comments received from the public, and other factors. As mentioned previously, the Board's standards-setting agenda is maintained on the Board's website. The Board is considering these comments as it assesses its agenda.

c. Comparison with and the Standards of the International Auditing and Assurance Standards Board the Auditing Standards Board of the American Institute of Certified Public Accountants

Some commenters on the reproposed standards stated that the Board should provide more information about its requirements, including how the requirements are expected to affect audits. Commenters requested information about how the Board's standards compare to the standards of other standards-setters. Some commenters also requested more explanation for certain requirements in the Board's reproposed standards.

In developing its original proposed standards, the Board took into account, among other things, the risk assessment standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board of the American Institute of Certified Public Accountants ("ASB"). The release accompanying the reproposed standards included a comparison of the objectives and requirements of the reproposed standards to the analogous standards of the IAASB and ASB.

Some commenters requested additional details about differences between the reproposed standards and the IAASB or ASB standards or clarifications regarding specific requirements in the reproposed standards for which the language was not identical to IAASB or ASB standards.

In analyzing comments on the appendix to the reproposed standards that compared the reproposed standards to the analogous standards of the IAASB and ASB, the Board observed that a number of the explanations sought by commenters, e.g., the reasons for the differences in certain requirements were discussed elsewhere in the release accompanying the reproposed standards, e.g., in Appendix 9 to that release.

The discussion below discusses certain differences between the objectives and requirements of the PCAOB standards and the analogous standards of the IAASB and ASB. When a difference between the Board's standards and the analogous standards of the IAASB and ASB is noted, the discussion contains a reference to the discussion of the Board's requirements in this release. This analysis may not represent the views of the IAASB or ASB regarding their standards.

Auditing Standard No. 8 – Audit Risk

Analogous discussions of the components of audit risk are included in the IAASB's International Standard on Auditing ("ISA") 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing and the ASB's clarified Statement on Auditing Standards ("SAS"), Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards, respectively.

(i) Audit Risk and Reasonable Assurance

PCAOB

Auditing Standard No. 8 states that to form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.[402/]

Auditing Standard No. 8 uses the phrase "appropriately low level" because the term "appropriately" is aligned more closely with the concept of reasonable assurance whereas "acceptable level" might be misunderstood as allowing auditors to vary the audit efforts based upon their personal tolerance for risk. This release contains additional discussion regarding the use of the phrase "appropriately low level."[403/]

[402/] AU sec. 110, Responsibilities and Functions of the Independent Auditor, and AU sec. 230, Due Professional Care in the Performance of Work, provide further discussion of reasonable assurance.

[403/] Section II.C.3.b.

Auditing Standard No. 8 also clarifies that obtaining sufficient appropriate audit evidence is part of applying due professional care. This release provides additional discussion regarding due professional care and sufficient appropriate audit evidence.[404/]

IAASB and ASB

The ISA states:

> To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

The SAS includes a requirement similar to the ISA's requirement.

(ii) Detection Risk and Substantive Procedures

PCAOB

Auditing Standard No. 8 states that as the appropriate level of detection risk decreases, the evidence from substantive procedures that the auditor should obtain increases. This requirement was adapted from AU sec. 319, Consideration of Internal Control in a Financial Statement Audit,[405/] and it parallels a requirement in Auditing

[404/] Section II.C.3.c.

[405/] AU sec. 319 is superseded by the risk assessment standards.

Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.[406] This release contains additional discussion regarding detection risk.[407]

IAASB and ASB

The ISA and the SAS do not include an analogous requirement.

Auditing Standard No. 9 – Audit Planning

In this section, the analogous IAASB and ASB standards are, unless indicated otherwise, ISA 300, Planning an Audit of Financial Statements, and the clarified SAS, Planning an Audit, respectively.

(i). Planning an Audit

PCAOB

Auditing Standard No. 9 contains a requirement to properly plan the audit. This requirement is consistent with the first standard of fieldwork in AU sec. 150, Generally Accepted Auditing Standards.

[406] Paragraph 37 of Auditing Standard No. 13.

[407] Section II.C.3.e.

IAASB and ASB

The ISA and the SAS do not include an analogous requirement, although planning the audit is referenced in the objectives of the standards.

(ii). Audit Strategy and Audit Plan

PCAOB

Auditing Standard No. 9 requires the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan. When developing the audit strategy and audit plan, the standard requires the auditor to evaluate whether certain matters specified in the standard are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures As discussed in this release, these matters are adapted from Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, and are important for both the audit of financial statements and an audit of internal control over financial reporting ("audit of internal control").[408/]

In establishing the overall audit strategy, Auditing Standard No. 9 also requires the auditor to take into account certain matters, such as the reporting objectives and the factors that are significant in directing the activities of the engagement team, results of

[408/] Section II.C.4.e.

preliminary engagement activities and the auditor's evaluation of the important matters in accordance with paragraph 7, and the nature, timing, and extent of resources necessary to perform the engagement. This release discusses this requirement with more detail.[409/]

Auditing Standard No. 9 requires the auditor to develop and document an audit plan that includes a description of the planned nature, timing, and extent of risk assessment procedures; tests of controls, substantive procedures, and other audit procedures. The audit plan required by Auditing Standard No. 9 encompasses all of the audit procedures to be performed, i.e., it is not limited to procedures at the assertion level. This release contains additional discussion regarding developing the audit strategy and audit plan.[410/]

IAASB and ASB

The ISA and the SAS require the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan. Those standards do not have a requirement analogous to the Auditing Standard No. 9 requirement to evaluate specific matters in developing the audit strategy and audit plan.

The ISA states:

> In establishing the overall audit strategy, the auditor shall:

409/ Section II.C.4.f.

410/ Ibid.

(a) Identify the characteristics of the engagement that define its scope;

(b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;

(c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;

(d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

(e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

The SAS includes a requirement similar to the ISA's requirement.

Both the ISA and the SAS require the auditor to develop an audit plan that shall include a description of the nature, timing, and extent of planned further auditor procedures at the assertion level.

(iii). Multi-location Engagements

PCAOB

Auditing Standard No. 9 states that the auditor should determine the extent to which auditing procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the audit procedures to be performed at those individual locations or business units. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit. Auditing Standard No. 9 also provides a list of factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures.

The provisions in Auditing Standard No. 9 are applicable to all multi-location audits. This release discusses the basis for the requirements and explains how the requirements should be applied in audits in which part of the work is performed by other auditors of financial statements of individual locations or business units that are included in the consolidated financial statements.[411/]

IAASB and ASB

ISA 600, Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors), and the proposed SAS, Audits of Group Financial Statements (Including the Work of Component Auditors), apply to group audits. Under ISA 600, group audits are defined as the audit of group financial statements, which are financial statements that include the financial information of more than one component, and the component auditor is an auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

ISA 600 and the proposed SAS describe the scope of audit procedures to be performed at individual components, depending upon, among other things, whether the components are significant components as described in the respective standards.

Auditing Standard No. 10 – Supervision of the Audit Engagement

In this section, unless indicated otherwise, the analogous IAASB standards are ISA 300, Planning an Audit of Financial Statements, and ISA 220, Quality Control for an Audit of Financial Statements, (collectively referred to in this section as "the ISAs"); and

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[411/] Section II.C.4.g.

the analogous ASB standards are the clarified SAS, Planning an Audit, and the proposed SAS, Quality Control for an Audit of Financial Statements, (collectively referred to in this section as "the SASs").

(i). Supervision

PCAOB

Auditing Standard No. 10 states that the engagement partner is responsible for supervising other engagement team members and may seek assistance from appropriate engagement team members. Auditing Standard No. 10 also requires the engagement partner, and engagement team members who assist the engagement partner in supervision, to properly supervise the members of the engagement team, describes the necessary elements of proper supervision, and describes the factors that affect the necessary extent of supervision. These requirements are adapted from AU sec. 311, Planning and Supervision.[412/] This release provides additional discussion regarding these requirements.[413/]

The requirements in the ISAs and the SASs do not describe the elements of supervision or factors that affect supervision.

412/ AU sec. 311 is superseded by Auditing Standard No. 9 and Auditing Standard No. 10.

413/ Section II.C.5.d.

IAASB and ASB

The ISAs and the SASs require the auditor to plan the nature, timing, and extent of direction and supervision of engagement team members and review their work. The ISAs and SASs require the engagement partner to "take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements and for the auditor's report being appropriate in the circumstances."

(ii). Supervision of Engagement Team Members

PCAOB

Auditing Standard No. 10 requires the engagement partner and other engagement team members performing supervisory activities to: (a) inform engagement team members of their responsibilities, including the objectives of the procedures that they are to perform; the nature, timing and extent of procedures they are to perform; and matters that could affect the procedures to be performed or the evaluation of the results of those procedures, (b) direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervising activities, and (c) review the work of engagement team members to evaluate whether the work was performed, the objectives of the procedures were achieved, and the results of the work support the conclusions. This release contains additional discussion regarding this requirement.[414/]

IAASB

The ISAs state:

> The engagement partner shall take responsibility for:
>
> (a) The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory and legal requirements; and
>
> (b) The auditor's report being appropriate in the circumstances.
>
> The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures.
>
> On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

[414/] Section II.C.5.e.

> The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

ASB

The SAS includes requirements similar to the ISAs' requirements.

(iii). Extent of Supervision

PCAOB

To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, Auditing Standard No. 10 requires the engagement partner and other engagement team members performing supervisory activities to take into account the nature of company, the nature of the assigned work for each team member, the risks of material misstatement, and the knowledge, skill, and ability of each engagement team member. This release contains additional discussion regarding this requirement.[415/]

IAASB and ASB

The ISAs and SASs do not have an analogous requirement for the auditor to determine the extent of supervision necessary for engagement team members.

[415/] Ibid.

Auditing Standard No. 11 – Consideration of Materiality in Planning and Performing an Audit

In this section, the analogous IAASB and ASB standards are ISA 320, Materiality in Planning and Performing an Audit, and the clarified SAS, Materiality in Planning and Performing an Audit, and the proposed SAS, Audits of Group Financial Statements (Including the Work of Component Auditors), respectively.

- **Definition of Materiality**

PCAOB

Auditing Standard No. 11 requires the auditor to establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances, including consideration of the company's earnings and other relevant factors. The requirement in Auditing Standard No. 11 is based on the concept of materiality that is articulated by the courts in interpreting the federal securities laws. This release discusses the concept of materiality used in Auditing Standard No. 11.[416/]

IAASB and ASB

The ISA states, "When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole."

[416/] Section II.C.6.b.

The SAS has a requirement similar to the ISA's requirement.

- **Materiality in the Context of an Audit**

PCAOB

Auditing Standard No. 11 requires the auditor to plan and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements in order to obtain reasonable assurance about whether the financial statements are free of material misstatement. This release discusses the concept of materiality in the context of an audit.[417/]

IAASB

ISA 200 states:

> In conducting an audit of financial statements, the overall objectives of the auditor are:
>
> a. To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements

[417/] Ibid.

are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

b. To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.

ASB

The SAS includes an objective similar to the ISA's objective.

- **Tolerable Misstatement and Performance Materiality**

PCAOB

Auditing Standard No. 11 requires the auditor to determine tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level. Auditing Standard No. 11 uses the term "tolerable misstatement," which is also used in other PCAOB standards.[418/] this release discusses the use of the term "tolerable misstatement" in more detail.[419/]

[418/] Paragraph .18 of AU sec. 350, Audit Sampling.

[419/] Section II.C.6.e.

IAASB and ASB

The ISA and SAS require the auditor to determine "performance materiality" for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures.

- **Determining Tolerable Misstatement**

PCAOB

Auditing Standard No. 11 contains a requirement to take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods when determining tolerable misstatement and planning and performing audit procedures. This requirement is adapted from AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*. This release contains further discussion regarding this requirement.[420/]

IAASB and ASB

The ISA and SAS do not have an analogous requirement.

[420/] Ibid.

- **Multi-location Determination of Tolerable Misstatement**

PCAOB

In multi-location engagements, Auditing Standard No. 11 requires the auditor to determine tolerable misstatement for the individual locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements. The standard also requires the tolerable misstatement at an individual location to be less than the established materiality level for the financial statements as a whole. This release provides further discussion regarding consideration of materiality for multi-location engagements.[421/]

IAASB

ISA 600 requires the group engagement team to determine, among other things, component materiality. The ISA states:

> Component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit. To reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a

[421/] Section II.C.6.f.

> whole, component materiality shall be lower than materiality for the group financial statements as a whole.

ASB

Proposed SAS, Audits of Group Financial Statements (Including the Work of Component Auditors), requires the group engagement team to determine among other things, component materiality. The proposed SAS states:

> Component materiality for those components on which an audit or other specified audit procedures will be performed. To reduce the risk that the aggregate of detected and undetected misstatements in the group financial statements exceeds the materiality for the group financial statements as a whole, component materiality should be lower than the materiality for the group financial statements as a whole.

- **Reevaluating Materiality and Tolerable Misstatement**

PCAOB

Auditing Standard No. 11 requires the auditor to reevaluate the established materiality level or levels and tolerable misstatement when there is a substantial likelihood that misstatements of amounts that differ significantly from the materiality level or levels that were established initially would influence the judgment of a reasonable investor. The requirement reflects the perspective of a reasonable investor, whereas the analogous requirements in the ISA and SAS reflect an auditor's perspective. This release contains additional discussion regarding materiality from the perspective of a reasonable investor[422/] and the reevaluation of materiality.[423/]

IAASB and ASB

The ISA and the SAS require the auditor to "revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances, or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially."

Auditing Standard No. 12 – Identifying and Assessing Risks of Material Misstatement

In this section, the analogous IAASB standards are ISA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment, and ISA 240, The Auditor's Responsibilities Relating to Fraud In An Audit of Financial Statements (collectively referred to in this section as "the ISAs"). The analogous ASB standards are the clarified SAS, Understanding the Entity and its Environment and Assessing the Risks of Material Misstatements (Redrafted) and

[422/] Section II.C.6.b.

[423/] Section II.C.6.g.

proposed SAS, Consideration of Fraud in a Financial Statement Audit (Redrafted) (collectively referred to in this section as "the SASs").[424/]

(i). Objective

PCAOB

The objective of Auditing Standard No. 12 is to identify and appropriately assess the risks of material misstatement, thereby providing a basis for designing and implementing responses to the risks of material misstatement. Auditing Standard No. 12 requires the auditor to perform other risk assessment procedures in addition to obtaining an understanding of the company and its environment. This release contains additional discussion regarding the objective of the standard.[425/]

IAASB and ASB

The ISAs state:

> The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the

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[424/] In June 2010, the ASB adopted as a final standard the SAS, Consideration of Fraud in a Financial Statement Audit (Redrafted). However, the ASB has not yet published this standard.

[425/] Section II.C.7.b.

> entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

The SASs include an objective similar to the ISAs' objective.

(ii). Performing Risk Assessment Procedures

PCAOB

Auditing Standard No. 12 states that the auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud, and designing further audit procedures. The requirement establishes a principle for determining the sufficiency of the necessary risk assessment procedures, and it also links the risk assessment procedures to the design of the tests of controls and substantive procedures to be performed to respond to the risks. This release includes additional discussion regarding performing risk assessment procedures.[426/]

IAASB and ASB

The ISAs state:

[426/] Section II.C.7.c.

> The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

The SASs include a requirement similar to the ISAs' requirement.

(iii). Obtaining an Understanding of the Company and Its Environment

PCAOB

Auditing Standard No. 12 includes a requirement to evaluate, while obtaining an understanding of the company, whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement. This release includes additional discussion regarding obtaining an understanding of the company and its environment.[427/]

IAASB and ASB

The ISAs and SASs do not include an analogous requirement.

[427/] Section II.C.7.d.

(iv). Additional Procedures to Understand the Company

PCAOB

Auditing Standard No. 12 requires the auditor to consider performing certain procedures as part of obtaining an understanding of the company as required by paragraph 7 of the standard. These procedures include reading public information about the company, observing or reading transcripts of earnings calls, obtaining an understanding of compensation arrangements with senior management, and obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders. This release includes additional discussion regarding this requirement.[428/]

IAASB and ASB

The ISAs and SASs do not include an analogous requirement.

(v). Selection and Application of Accounting Principles, Including Related Disclosures

PCAOB

Auditing Standard No. 12 requires the auditor to develop expectations about the disclosures that are necessary for the company's financial statements to be presented

[428/] Ibid.

fairly in conformity with the applicable financial reporting framework to identify and assess the risks of material misstatement related to omitted, incomplete, or inaccurate disclosures.[429/] The standard also requires engagement team members to discuss how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures.[430/] Additionally Auditing Standard No. 12 requires the auditor's evaluation of fraud risk factors to include how fraud could be perpetrated or concealed by presenting incomplete or inaccurate disclosures or by omitting disclosures that are necessary for the financial statements to be presented fairly in conformity with the applicable financial reporting framework.[431/] This release includes additional discussion regarding these requirements.[432/]

IAASB and ASB

The ISAs and SASs do include analogous requirements regarding the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.

429/ Paragraph 12 of Auditing Standard No. 12.

430/ Paragraph 52 of Auditing Standard No. 12.

431/ Paragraph 67 of Auditing Standard No. 12.

432/ Section II.C.7.d., h. and j. respectively.

(vi). Obtaining an Understanding of Internal Control Over Financial Reporting

PCAOB

Auditing Standard No. 12 requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements; (b) assess the factors that affect the risks of material misstatement; and (c) design further auditor procedures. This requirement relates to the sufficiency of the required understanding of internal control over financial reporting. This release contains additional discussion of this requirement.[433/]

IAASB and ASB

The ISAs state:

> The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

The SASs include requirements similar to the ISAs' requirements.

433/ Section II.C.7.e.

(vii). Control Environment

PCAOB

Auditing Standard No. 12 requires the auditor to assess the following matters as part of obtaining an understanding of the control environment:

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

This requirement is aligned with a similar requirement in Auditing Standard No. 5. This release includes additional discussion regarding this requirement.[434/]

Paragraph 25 of Auditing Standard No. 12 states that "[i]f the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor." This release

[434/] Section II.C.7.e.(ii).

includes additional discussion regarding the auditor's evaluation of an identified control deficiency in the control environment.[435/]

IAASB and ASB

The ISAs state:

> The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
>
> (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
>
> (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment.

The SASs include requirements similar to the ISAs' requirements.

[435/] Ibid.

The ISAs and SASs do not have a requirement analogous to paragraph 25 of Auditing Standard No. 12.

(viii). The Company's Risk Assessment Process

PCAOB

Auditing Standard No. 12 states that:

> The auditor should obtain an understanding of management's process for:
>
> (a) Identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud ("fraud risks"),
>
> (b) Assessing the likelihood and significance of misstatements resulting from those risks, and
>
> (c) Deciding about actions to address those risks.
>
> The standard also states that obtaining an understanding of the company's risk assessment process includes obtaining an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.

Those requirements focus on the matters that are important to the auditor's understanding of the company's internal control and on the auditor's risk assessments. Although the auditor can be informed by the company's risk assessment process, the auditor is still required to perform risk assessment procedures that are sufficient for identifying and assessing the risks of material misstatement rather than relying on the company's process.

This release includes additional discussion regarding the company's risk assessment process.[436/]

IAASB and ASB

The ISAs state:

> The auditor shall obtain an understanding of whether the entity has a process for (a) Identifying business risks relevant to financial reporting objectives; (b) Estimating the significance of the risks; (c) Assessing the likelihood of their occurrence; and (d) Deciding about actions to address those risks.
>
> If the entity has established such a process (referred to hereafter as the "entity's risk assessment process"), the auditor shall obtain an understanding of it, and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify,

436/ Section II.C.7.e.(iii).

> the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process.
>
> If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control.

The SASs include requirements similar to the ISAs' requirements.

(ix). Information and Communication

PCAOB

Auditing Standard No. 12 requires the auditor to obtain an understanding of how IT affects the company's flow of transactions. The standard also states that the identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the approach used to identify significant accounts and disclosures and their relevant assertions and, when applicable, to select the controls to test, as well as to assess risk and allocate audit effort. This release contains additional discussion of this requirement.[437/]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(x). Control Activities

PCAOB

Auditing Standard No. 12 requires the auditor to obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures. Auditing Standard No. 12 requires the auditor to use his or her knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control over financial reporting in determining the extent to which it is necessary to devote additional attention to obtaining an understanding of control activities to assess the factors that

437/ Section II.C.7.e.(iv).

affect the risks of material misstatement and to design further audit procedures. This release includes additional discussion of this requirement.[438/]

IAASB

The ISAs state:

> The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them.

ASB

The SASs state:

> The auditor should obtain an understanding of control activities relevant to the audit, which are those control activities the auditor judges it necessary to understand in order to assess the risks of

[438/] Section II.C.7.e.(v).

> material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. However, the auditor should obtain an understanding of the process of reconciling detailed records to the general ledger for material account balances.

(xi). Relationship of Understanding of Internal Control to Tests of Controls

PCAOB

Auditing Standard No. 12 requires the auditor to take into account the evidence obtained from understanding internal control when assessing control risk and, in the audit of internal control, forming conclusions about the effectiveness of controls. Auditing Standard No. 12 also requires the auditor to take into account the evidence obtained from understanding internal control when determining the nature, timing, and extent of procedures necessary to support the auditor's conclusions about the effectiveness of entity-level controls in the audit of internal control. This release includes additional discussion of these requirements.[439/]

[439/] Section II.C.7.e.(vii).

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(xii). Considering Information from the Client Acceptance and Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements

PCAOB

Auditing Standard No. 12 requires the auditor to evaluate whether information obtained during a review of interim financial information in accordance with AU sec. 722, Interim Financial Information, is relevant to identifying risks of material misstatement in the year-end audit. The ISAs and SASs do not include an analogous requirement.

Auditing Standard No. 12 also states that the auditor should obtain an understanding of the nature of the services that have been performed for the company by the auditor or affiliates of the firm[440/] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement. The requirement in Auditing Standard No. 12 applies to services performed by the firm and

[440/] See PCAOB Rule 3501(a)(i), which defines "affiliate of the accounting firm."

affiliates of the firm and is not limited to services performed by the engagement partner. This release contains additional discussion regarding these requirements.[441/]

IAASB and ASB

The ISAs state, "[i]f the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement."

The SASs include a requirement similar to the ISAs' requirement.

(xiii). Performing Analytical Procedures

PCAOB

Auditing Standard No. 12 contains a series of requirements regarding performing analytical procedures as risk assessment procedures. These requirements were adapted from AU sec. 329, Analytical Procedures. Auditing Standard No. 12 requires the auditor to:

- Perform analytical procedures that are designed to (a) enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior year end; and (b) identify areas that might represent specific risks relevant to the audit,

441/ Section II.C.7.f.(ii).

including the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.

- Perform analytical procedures regarding revenue as risk assessment procedures with the objective of identifying unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud.

- Take into account analytical procedures performed in accordance with AU sec. 722 when designing and applying analytical procedures as risk assessment procedures. This requirement is unique to PCAOB standards.

- Use his or her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure.[442/]

- Take into account unusual or unexpected differences from the auditor's expectations that are identified while performing analytical procedures as risk assessment procedures.

This release contains additional discussion of these requirements.[443/]

[442/] Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

[443/] Section II.C.7.g.

IAASB

The ISAs state:

> The risk assessment procedures shall include...[a]nalytical procedures…

> The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

ASB

The SASs state:

> The risk assessment procedures should include...[a]nalytical procedures…

> Based on analytical procedures performed as part of risk assessment procedures and as part of substantive procedures, the auditor should evaluate whether unusual or unexpected relationships that have been identified indicate risks of material misstatements due to fraud. To the extent not already included, the

analytical procedures and evaluation thereof should include procedures relating to revenue accounts.

(xiv). Communication among Engagement Team Members

PCAOB

Auditing Standard No. 12 requires that the communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change. This release contains additional discussion of this requirement.[444/]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(xv). Discussion of the Potential for Material Misstatement Due to Fraud

PCAOB

Auditing Standard No. 12 requires a discussion among the key engagement team members of specified matters regarding fraud, including how and where the company's financial statements might be susceptible to material misstatement due to fraud, known

[444/] Section II.C.7.h.(ii).

fraud risk factors, the risk of management override of controls, and possible responses to fraud risks.

Auditing Standard No. 12 requires all key engagement team members to participate in the discussion. Auditing Standard No. 12 also states that key engagement team members include the engagement partner and other engagement team members with significant engagement responsibilities.

Auditing Standard No. 12 also includes a requirement to emphasize certain matters to all engagement team members, including the need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, to be alert for information or other conditions that might affect the assessment of fraud risks, and actions to be taken if information or other conditions indicate that a material misstatement due to fraud might have occurred.

This release includes additional discussion of these requirements.[445/]

IAASB

The ISAs state:

> The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to

[445/] Section II.C.7.h.

> material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion.
>
> …This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.

ASB

The SASs have requirements similar to the ISAs' requirements. However, the SASs also include a requirement that the discussion regarding fraud include an exchange among engagement team members about how and where the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. The SASs also include a requirement to emphasize certain matters to all engagement team members, but those matters identified are less extensive than those required by PCAOB standards.

(xvi). Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

PCAOB

Auditing Standard No. 12 requires the auditor to make specified inquiries of management and the audit committee regarding tips or complaints about the company's financial reporting. This release includes additional discussion of this requirement.[446/]

IAASB and ASB

The ISAs and the SASs do not specify the nature of the required inquiries, except for certain inquiries regarding fraud, which are less extensive than those required by PCAOB standards.

(xvii). Nature of Inquiries

PCAOB

Auditing Standard No. 12 requires the auditor to use his or her knowledge of the company and its environment, as well as information from other risk assessment procedures, to determine the nature of inquiries about risks of material misstatement. This release includes additional discussion of this requirement.[447/]

446/ Section II.C.7.i.

447/ Ibid.

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(xviii). Evaluating Management Responses to Inquiries

PCAOB

Auditing Standard No. 12 requires the auditor to take into account the fact that management is often in the best position to commit fraud when evaluating management's responses to inquiries about fraud risks. Auditing Standard No. 12 also requires the auditor to obtain evidence to address inconsistencies in response to the inquiries. This release includes additional discussion of these requirements.[448/]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

[448/] Ibid.

(xix). Identifying and Assessing the Risks of Material Misstatement

PCAOB

Auditing Standard No. 12 requires the auditor to evaluate how risks at the financial statement level could affect risks of material misstatement at the assertion level. This release includes additional discussion of this requirement.[449/]

IAASB and ASB

The ISAs and the proposed SAS do not include an analogous requirement.

(xx). Identifying Significant Accounts and Disclosures and Their Relevant Assertions

PCAOB

Auditing Standard No. 12 requires the auditor to identify significant accounts and disclosures and their relevant assertions in identifying and assessing risks of material misstatement. PCAOB standards require auditors to perform substantive procedures for relevant assertions of significant accounts and disclosures in the audit of financial statements and tests of controls over relevant assertions of significant accounts and

449/ Section II.C.7.j.

disclosures in the audit of internal control. This release includes additional discussion regarding identifying significant accounts and disclosures and relevant assertions.[450/]

IAASB and ASB

The ISAs and SASs do not have an analogous requirement.

(xxi). Significant Risks

PCAOB

Auditing Standard No. 12 defines significant risk as a "risk of material misstatement that requires special audit consideration." This definition is different from the ISAs' definition because it omits two qualifying phrases, "an identified and assessed" and "in the auditor's judgment." This release includes additional discussion regarding the definition of significant risks.[451/]

IAASB and ASB

The ISAs and SASs define significant risk as "an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration."

[450/] Ibid.

[451/] Section II.C.7.k.

Auditing Standard No. 13 – The Auditor's Responses to the Risks of Material Misstatement

In this section, the analogous IAASB standards are ISA 330, The Auditor's Responses to Assessed Risks, and ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements (collectively referred to in this section as "the ISAs"). The analogous ASB standards are the clarified SAS, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (Redrafted), and the proposed SAS, Consideration of Fraud in a Financial Statement Audit (Redrafted) (collectively referred to in this section as "the SASs").

(i). Objective

PCAOB

The objective of the auditor in Auditing Standard No. 13 is "to address the risks of material misstatement through appropriate overall audit responses and audit procedures." The objective in the proposed standard emphasizes the auditor's responsibility for responding to the risks of material misstatements. This release contains additional discussion regarding the objective of the standard.[452/]

[452/] Section II.C.8.b.

IAASB and ASB

The objective in the ISAs and the SASs is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

(ii). Overall Responses to Risks

PCAOB

Auditing Standard No. 13 requires the auditor to design and implement certain overall responses (e.g., making appropriate assignments of specific engagement responsibilities, providing an appropriate extent of supervision, incorporating elements of unpredictability in selecting auditing procedures, and evaluating the company's selection and application of significant accounting principles) to address risks of material misstatement. These responses are not limited to addressing risks at the financial statement level. They are also intended to address risks at the significant account or disclosure level due to the nature of these specific overall responses. This release contains additional discussion of this requirement.[453/]

[453/] Section II.C.8.c.

IAASB and ASB

The ISAs and the SASs include requirements to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level and requirements for particular types of responses to the risks of material misstatement due to fraud at the financial statement level.

(iii). Determination of the Need for Pervasive Changes

PCAOB

Auditing Standard No. 13 requires the auditor to determine whether it is necessary to make pervasive changes to the nature, timing, or extent of audit procedures to adequately address the assessed risk of material misstatement. Examples of such pervasive changes include modifying the audit strategy to increase the substantive testing of the valuation of numerous significant accounts at year end because of significantly deteriorating market conditions and to obtain more pervasive audit evidence from substantive procedures due to the identification of pervasive weaknesses in the company's control environment. This release includes detailed discussions regarding making pervasive changes as an overall response to risks of material misstatement.[454/]

[454/] Ibid.

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(iv). Application of Professional Skepticism

PCAOB

Auditing Standard No. 13 states that due professional care requires the auditor to exercise professional skepticism, requires that the auditor apply professional skepticism in gathering and evaluating audit evidence in response to risks of material misstatement, and provides examples of the appropriate application of professional skepticism. This release includes additional discussion regarding application of professional skepticism.[455/]

IAASB and ASB

The ISAs state

> …the auditor shall maintain an attitude of professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.

[455/] Ibid.

The SASs include a requirement similar to the ISAs' requirement.

(v). Evidence about the Effectiveness of Controls

PCAOB

In discussing testing controls in an audit of financial statements, Auditing Standard No. 13 establishes the principle that the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The greater the reliance on a control, the more persuasive evidence the auditor is required to obtain from the tests of controls.

In addition, the standard requires the auditor to obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls. This release includes additional discussions of these requirements.[456/]

IAASB and ASB

The ISAs and the SASs include a requirement for the auditor to obtain more persuasive audit evidence the greater the reliance he or she plans to place on the effectiveness of a control, but they do not have an analogous requirement regarding situations in which the audit approach consists primarily of tests of controls.

[456/] Section II.C.8.f.(iii).

(vi). Testing the Operating Effectiveness of a Control

PCAOB

Auditing Standard No. 13 requires the auditor to determine whether the control selected for testing is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. The standard also discusses the procedures the auditor performs in testing operating effectiveness. To help facilitate the tests of controls in an integrated audit, the standard continues to use language similar to that of Auditing Standard No. 5 when describing analogous terms and concepts relating to the testing of controls. This release includes additional discussion regarding this requirement.[457/]

IAASB

The ISAs do not include an analogous requirement to determine whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

ASB

The SASs state:

> In designing and performing tests of controls, the auditor should:

[457/] Section II.C.8.f.(iv).

> *a.* perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including …by whom or by what means they were applied, including, when applicable, whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

(vii). Tests of Controls in an Integrated Audit

PCAOB

Auditing Standard No. 13 requires the auditor to perform tests of controls in integrated audits to meet the objectives of both the audit of financial statements and the audit of internal control. This release includes additional discussion of this requirement.[458/]

IAASB and ASB

The ISAs and the SASs do not include an analogous requirement.

458/ Section II.C.8.d.

(viii). Rotational Testing of Controls

PCAOB

Auditing Standard No. 13 requires the auditor to obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies. This release includes additional discussion of this requirement.[459/]

IAASB and ASB

The ISAs and the SASs include requirements that apply to the use of evidence about controls obtained in prior audits and allow rotational testing of controls under certain conditions set forth in those standards.

(ix). Assessing Control Risk

PCAOB

Auditing Standard No. 13 requires the auditor to assess control risk for relevant assertions by evaluating the evidence from all sources, including the auditor's testing of controls for the audit of internal control and the audit of financial statements, misstatements detected during the financial statement audit, and any identified control deficiencies. The standard also requires that control risk be assessed at the maximum level for relevant assertions (1) for which controls necessary to sufficiently address the

[459/] Section II.C.8.f.(vi).

assessed risk of material misstatement in those assertions are missing or ineffective or (2) when the auditor has not obtained sufficient appropriate audit evidence to support a control risk assessment below the maximum level. This release includes additional discussion of these requirements.[460/]

IAASB and ASB

The ISAs and the SASs include requirements regarding evaluating the operating effectiveness of controls and identified control deviations, but those standards do not require a specific assessment of control risk.

(x). Substantive Procedures

PCAOB

Auditing Standard No. 13 requires the auditor to perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk. This requirement reflects the principle that the auditor needs to implement appropriate responses to address assessed risks of material misstatement. This release contains additional discussion of this requirement.[461/]

[460/] Section II.C.8.f.(vii).

[461/] Section II.C.8.g.

IAASB

The ISAs state, "Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure."

ASB

The SASs state, "Irrespective of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure."

The requirements in the ISAs and the SASs focus on the accounts and disclosures that are material, regardless of whether they are associated with identified risks of material misstatement.

(xi). Consideration of Confirmations

PCAOB

Auditing Standard No. 13 requires the auditor to perform substantive procedures for each relevant assertion of each significant account and disclosure. The standard also discusses how to determine the types and combination of substantive audit procedures necessary to detect material misstatements in relevant assertions.

AU sec. 330, The Confirmation Process, establishes requirements regarding the use of confirmation procedures.[462] The risk assessment standards discuss the auditor's responsibilities for designing and performing the substantive procedures necessary to address the risks of material misstatement.

IAASB and ASB

ISA 330 specifically requires the auditor to consider whether external confirmation procedures are to be performed as substantive audit procedures. The ASB has proposed to amend the SASs to require the auditor to consider whether external confirmation procedures are to be performed as substantive audit procedures and to require the use of external confirmation procedures for material accounts receivable.

(xii). Determining Whether to Perform Interim Substantive Procedures

PCAOB

Auditing Standard No. 13 requires the auditor to take into account a series of factors when determining whether it is appropriate to perform substantive procedures at an interim date. This release includes provides additional discussion regarding timing of substantive procedures.[463]

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[462] The Board has a separate standards-setting project on confirmations.

[463] Section II.C.8.h.

IAASB and ASB

The ISAs and the SASs do not include an analogous requirement for the auditor to take into account the factors listed in Auditing Standard No. 13 when determining whether it is appropriate to perform substantive procedures at an interim date.

(xiii). Substantive Procedures Covering the Remaining Period

PCAOB

Auditing Standard No. 13 states, "When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end." The standard contains a specific requirement to compare relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual. This release includes additional discussion of this requirement.[464/]

IAASB and ASB

The ISAs and the SASs include requirements to cover the period between the interim testing date and year end by performing substantive procedures, combined with

[464/] Ibid.

tests of controls for the intervening period, or by performing further substantive procedures only if the auditor determines that doing so would be sufficient. The ISAs and SASs do not include an analogous requirement regarding the specific procedures to be performed.

(xiv). Response to Significant Risks

PCAOB

Auditing Standard No. 13 requires the auditor to perform substantive procedures, including tests of details, that are specifically responsive to significant risks. This release contains additional discussion of this requirement.[465/]

IAASB and ASB

The ISAs state:

> If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

[465/] Section II.C.8.i.

The SASs include requirements similar the ISAs' requirements.

(xv). Dual-purpose Tests

PCAOB

Auditing Standard No. 13 states that, when dual-purpose tests are performed, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested. This release contains additional discussion of this requirement.[466/]

IAASB and ASB

The ISAs and the SASs do not include analogous requirements.

Auditing Standard No. 14 – Evaluating Audit Results

In this section, the analogous IAASB standards are ISA 450, Evaluation of Misstatements Identified During the Audit, ISA 330, The Auditor's Responses to Assessed Risks, ISA 520, Analytical Procedures, ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements, ISA 540, Auditing Accounting Estimates Including Fair Value Accounting Estimates, and Related Disclosures, and ISA

[466/] Section II.C.8.j.

700, Forming an Opinion and Reporting on Financial Statements (collectively referred to in this section as "the ISAs"). The analogous ASB standards are clarified SAS Evaluation of Misstatements Identified During the Audit, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (Redrafted), Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement (Redrafted), and proposed SAS Consideration of Fraud in a Financial Statement Audit (Redrafted), Analytical Procedures (Redrafted), and Forming an Opinion and Reporting on Financial Statements (collectively referred to in this section as "the SASs").

(i). Performing Analytical Procedures in the Overall Review

PCAOB

In the overall review, Auditing Standard No. 14 contains specific requirements for the auditor to read the financial statements and disclosures and perform analytical procedures to (a) evaluate the auditor's conclusions formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement. These requirements were adapted from existing requirements in PCAOB standards.[467/] The conclusions formed from the results of the overall review of the audit are intended to inform the auditor's conclusions

[467/] AU sec. 329.23.

regarding significant accounts and disclosures and the opinion on the financial statements. This release includes additional discussion of these requirements.[468/]

IAASB

The ISAs state:

> The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

ASB

The SASs state:

> The auditor should design and perform analytical procedures near the end of the audit that are intended to corroborate audit evidence obtained during the audit of financial statements to assist the auditor in drawing reasonable conclusions on which to base the auditor's opinion.

[468/] Section II.C.9.c.

(ii). Evaluating Evidence from Analytical Procedures

PCAOB

Auditing Standard No. 14 contains a requirement, which was adapted from an existing requirement in PCAOB standards,[469/] for the auditor, as part of the overall review to evaluate whether (a) the evidence gathered in response to unusual or unexpected transactions, events, amounts or relationships previously identified during the audit is sufficient and (b) unusual or unexpected transactions, events, amounts, or relationships indicate risks of material misstatement that were not identified previously, including, in particular, fraud risks. Auditing Standard No. 14 also specifically requires the auditor to evaluate whether the evidence gathered during the audit is sufficient as part of the overall review.

Also, the requirements in Auditing Standard No. 14 relate to risks of material misstatement due to error or fraud, whereas the requirements in the ISAs and SASs are limited to fraud risks. This release includes additional discussion of these requirements in Auditing Standard No. 14.[470/]

IAASB

The ISAs state:

469/ AU sec. 329.23.

470/ Section II.C.9.c.

> The auditor shall evaluate whether analytical procedures that are performed near the end of the audit, when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment, indicate a previously unrecognized risk of material misstatement due to fraud.

ASB

The SASs state:

> The auditor should evaluate whether the accumulated results of auditing procedures, including analytical procedures, that are performed during the audit, in the overall review stage, or in both stages, when forming an overall conclusion concerning whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment, indicate a previously unrecognized risk of material misstatement due to fraud.

(iii). Analytical Procedures Regarding Revenue

PCAOB

Auditing Standard No. 14 includes a requirement, adapted from an existing requirement in AU sec. 316, for the auditor to perform analytical procedures relating to revenue through the end of the period. These procedures are intended to identify unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud. This release includes additional discussion of this requirement.[471/]

IAASB

The ISAs state:

> The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

The ISAs do not specifically require the auditor to perform analytical procedures related to revenue through the end of the period.

471/ Ibid.

ASB

The SASs require the auditor to perform analytical procedures related to revenue.

(iv). Corroborating Management Explanations

PCAOB

Auditing Standard No. 14 requires the auditor to corroborate management's explanations regarding significant unusual or unexpected transactions, events, amounts, or relationships. Auditing Standard No. 14 also states that if management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures to address the matter. Unlike the ISAs, Auditing Standard No. 14 specifically requires the auditor to corroborate management's explanations regarding significant matters. This release includes additional discussion regarding corroborating management's explanations.[472/]

IAASB and ASB

The ISAs and the SASs require the auditor to investigate the identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount by (a) inquiring of management and

[472/] Ibid.

obtaining appropriate audit evidence relevant to management's responses and (b) performing other audit procedures as necessary in the circumstances. The ISAs and the SASs also include a requirement to investigate inconsistent responses to inquiries from management and those charged with governance.

(v). Communication of Accumulated Misstatements

PCAOB

Auditing Standard No. 14 requires the auditor to communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them. Unlike the ISAs and the SASs, Auditing Standard No. 14 does not require the auditor to request management to correct the misstatements. Instead, PCAOB standards focus on communicating the misstatements to management, performing procedures to determine whether management corrected them, understanding the reasons why management might not have corrected the misstatements, and evaluating the effect of uncorrected misstatements on the financial statements and the audit. This release includes additional discussion of this requirement.[473/]

IAASB and ASB

The ISAs and the SASs include requirements to communicate on a timely basis all misstatements accumulated during the audit to an appropriate level of management

[473/] Section II.C.9.j.

and to request that management correct those misstatements.

(vi). Correction of Misstatements

PCAOB

Auditing Standard No. 14 requires that if management has made corrections to accounts or disclosures in response to misstatements detected by the auditor, the auditor should evaluate management's work to determine whether the corrections have been appropriately recorded and determine whether uncorrected misstatements remain. This release includes additional discussion of this requirement.[474/]

IAASB and ASB

The ISAs and the SASs contain a requirement to perform additional audit procedures to determine whether misstatements remain, if at the auditor's request management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected.

The ISAs do not require the auditor to evaluate whether the misstatements that were communicated by the auditor to management have been appropriately corrected by management.

474/ Section II.C.9.f.

(vii). Evaluating Misstatements – Effect on Risk Assessments

PCAOB

Auditing Standard No. 14 contains a requirement to evaluate the nature and the effects of individual misstatements accumulated during the audit on the assessed risks of material misstatement in determining whether the risk assessments remain appropriate. This release includes additional discussion of this requirement.[475/]

IAASB and ASB

The ISAs and the SASs do not include an analogous requirement.

(viii). Evaluating Whether Misstatements Might Be Indicative of Fraud

PCAOB

Auditing Standard No. 14 requires the auditor to perform procedures to obtain additional audit evidence to determine whether fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report if the auditor believes that a misstatement is or might be intentional, and if the effect on the

[475/] Section II.C.9.i.

financial statement cannot be readily determined. This release includes additional discussions of this requirement.[476/]

IAASB and ASB

The ISAs require the auditor to evaluate the implications for the audit if the auditor confirms that or is unable to conclude whether financial statements are materially misstated as a result of fraud. The ISA does not explicitly require the auditor to perform audit procedures to obtain additional audit evidence to determine the effect of the misstatement on the financial statements.

The SASs include a requirement similar to the ISAs' requirement.

(ix). Communications Regarding Fraud

PCAOB

Auditing Standard No. 14 requires the auditor to determine his or her responsibility under AU secs. 316.79-.82A, AU sec. 317, Illegal Acts by Clients, and Section 10A of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j-1, if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred. AU sec. 316 requires that whenever the auditor has determined that there is evidence that fraud may exist, the auditor should bring that matter to the attention

[476/] Ibid.

of an appropriate level of management.[477/] This release includes additional discussion of this requirement.[478/]

IAASB and ASB

The ISAs state that if the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management.

The SASs include a requirement similar to the ISAs' requirement.

(x). Evaluating the Qualitative Aspects of the Company's Accounting Practices

PCAOB

Auditing Standard No. 14 states that if the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. The standard also contains a requirement for the auditor to evaluate whether the auditor's risk

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477/ AU sec. 316.79.

478/ Section II.C.9.k.

assessments, including the assessment of fraud risks, and the related responses remain appropriate. This release includes additional discussion of these requirements.[479/]

IAASB and ASB

The ISAs and the SASs contain a requirement for the auditor to evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

(xi). Management's Identification of Offsetting Adjusting Entries

PCAOB

If management identifies adjusting entries that offset misstatements accumulated by the auditor, Auditing Standard No. 14 requires the auditor to perform procedures to determine why the misstatements were not identified previously and to evaluate the implications on the integrity of management and the auditor's risk assessments, including fraud risk assessments. Auditing Standard No. 14 also requires the auditor to perform

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479/ Section II.C.9.l.

additional procedures as necessary to address the risk of further undetected misstatements. This release includes additional discussion of these requirements.[480/]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(xii). Evaluating Conditions Relating to Assessment of Fraud Risks

PCAOB

Auditing Standard No. 14 requires the engagement partner to determine whether there has been appropriate communication with other engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks. This release includes additional discussion of this requirement.[481/]

IAASB

The ISAs require a discussion among the engagement team members and a determination by the engagement partner of matters to be communicated to those team members not involved in the discussion.

[480/] Ibid.

[481/] Section II.C.9.m.

ASB

The SASs contain a requirement for the engagement partner to ascertain that appropriate communication exists about the need for the discussion of fraud risks among team members throughout the audit.

Auditing Standard No. 15 – Audit Evidence

In this section, the analogous IAASB and ASB standards are ISA 500, Audit Evidence, and the clarified SAS, Audit Evidence (Redrafted), respectively.

(i). Objective and Overarching Requirement

PCAOB

The objective of the auditor in Auditing Standard No. 15 is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report. The objective of the standard, together with the related requirement regarding audit evidence, articulates the linkage between the auditor's responsibility to obtain sufficient appropriate audit evidence and to support his or her opinion. This release includes additional discussion regarding the objective of the standard.[482/]

[482/] Section II.C.10.c.

<u>IAASB and ASB</u>

The ISA states:

> The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

The ISA also states:

> The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

The SAS includes an objective and a requirement similar to the ISA's objective and requirement.

(ii). Document Authentication

<u>PCAOB</u>

Auditing Standard No. 15 states that the auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor is required to modify the planned audit procedures or perform additional audit procedures to respond to those conditions and to evaluate the effect, if any, on the other aspects of the audit. Auditing Standard No. 15 omits protective language, such as "[u]nless the auditor has reason to believe the contrary, the auditor may accept records and document as genuine" that would weaken the requirement. This release includes additional discussion regarding this requirement.[483/]

IAASB and ASB

The ISA states:

> Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further.

The SAS includes a requirement similar to the ISA's requirement.

[483/] Section II.C.10.e.

(iii). Selecting Items for Testing to Obtain Audit Evidence

PCAOB

Auditing Standard No. 15 states that the auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. This requirement links the selection of items for testing to the sufficiency of the audit evidence. This release includes additional discussion of this requirement.[484/]

IAASB and ASB

The ISA states:

> When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure.

The SAS includes a requirement similar to the ISA's requirement.

III. Date of Effectiveness of the Proposed Rules and Timing for Commission Action

Pursuant to Section 19(b)(2)(A)(ii) of the Securities Exchange Act of 1934 ("Exchange Act"), and based on its determination that an extension of the period set forth

[484/] Section II.C.10.j.

in Section 19(b)(2)(A)(i) of the Exchange Act is appropriate in light of the number and complexity of the standards to allow additional time sufficient for notice and comment, consideration of comments, the Commission has determined to extend to [insert date 90 days from the date of publication in the Federal Register] as the date by which the Commission should take action on the proposed rule.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule is consistent with the requirements of Title I of the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/pcaob.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number PCAOB-2010-01 on the subject line.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number PCAOB-2010-01. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/pcaob/shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule that are filed with the Commission, and all written communications relating to the proposed rule between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. PCAOB-2010-01 and should be submitted on or before [insert 21 days from publication in the Federal Register].

By the Commission.

Elizabeth M. Murphy
Secretary

PCAOB
Public Company Accounting Oversight Board

1666 K Street, NW
Washington, D.C. 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8430
www.pcaobus.org

PROPOSED AUDITING STANDARDS RELATED TO THE AUDITOR'S ASSESSMENT OF AND RESPONSE TO RISK AND CONFORMING AMENDMENTS TO PCAOB STANDARDS	PCAOB Release No. 2008-006 October 21, 2008 PCAOB Rulemaking Docket Matter No.026

Summary: The Public Company Accounting Oversight Board (the "Board" or "PCAOB") is proposing changes to its auditing standards related to the auditor's assessment of and response to risk. Appendices 1 - 8 contain the text of the proposed auditing standards and proposed conforming amendments to PCAOB auditing standards.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 026 in the subject or reference line and should be received by the Board no later than 5:00 p.m. EDT on February 18, 2009.

Board Contacts: Keith Wilson, Associate Chief Auditor (202/207-9134; wilsonk@pcaobus.org), Hasnat Ahmad, Assistant Chief Auditor (202/207-9349, ahmadh@pcaobus.org), Diane Jules, Assistant Chief Auditor (202/ 207-9111, julesd@pcaobus.org).

A. Introduction

The Board is proposing seven auditing standards that would, collectively, update the requirements for assessing and responding to risk during an audit. The existing

RELEASE

auditing standards regarding risk assessment were adopted, for the most part, during the 1980s. As described below, these proposals have been informed by a number of factors and developments since that time. These include improvements that many firms have made in their audit methodologies; recommendations to the profession on ways in which auditors could improve risk assessment; advice from the Board's Standing Advisory Group ("SAG"); the adoption of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*; and observations from the Board's oversight activities. The proposals build upon and attempt to improve the framework established by the existing standards, rather than replacing that framework altogether. Accordingly, while the Board is proposing to supersede several of its interim standards, the concepts underpinning the proposed standards should be familiar to most auditors.

At the most basic level, the proposed standards are, like the existing standards, rooted in the concept of audit risk. Audit risk can be described as the risk that the auditor will express an inappropriate opinion when the financial statements are materially misstated. The objective of an audit of financial statements is to limit audit risk to a low level, so that the auditor can opine with reasonable assurance that the financial statements present fairly, in all material respects, a company's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles ("GAAP"). Prior to the 1980s, auditing standards said little about how to assess and manage the risks inherent in the audit process. For many years, risk assessment was largely confined to assessing the risks inherent in the accounts and performing a study and evaluation of internal control. Testing of financial statement accounts was often based primarily on the size and nature of the accounts. The formal assessment of risk occurred primarily when auditors applied audit sampling methods.

In the 1980s, generally accepted auditing standards began to apply audit risk concepts to the entire audit, not just to audit sampling.[1/] The standards adopted during this period explain that audit risk consists of the risk that the financial statements are materially misstated due to fraud or error and the risk that the auditor would fail to detect that the financial statements are materially misstated. These standards, which the Board adopted as interim auditing standards in 2003, describe in general terms the auditor's responsibilities for assessing and responding to risk, and direct auditors to vary the amount of audit effort related to particular financial statement accounts based on the risks presented by them.[2/] The standards also allowed the auditor more discretion to

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[1/] See, e.g., AU sec. 312, *Audit Risk and Materiality in Conducting an Audit.*

[2/] Examples of those standards include AU sec. 312 and AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit.*

RELEASE

use testing of controls as a basis for reducing substantive testing.[3] In general terms, these standards require the auditor to use judgment in assessing risks and then in deciding what procedures to perform to respond to those risks.[4]

In 1998, at the request of Securities and Exchange Commission ("SEC") Chairman Arthur Levitt, the Public Oversight Board ("POB") appointed the Panel on Audit Effectiveness ("PAE").[5] Chaired by Shaun O'Malley, former Chair of Price Waterhouse LLP, the PAE was broadly charged with assessing whether public company audits were adequately serving and protecting the interests of investors.[6] To do so, the panel "reviewed and evaluated the way that audits are performed," "assessed recent trends in audit practices to determine whether they are in the public interest," "studied the audit policies, methodologies and other forms of guidance used primarily by the large audit firms, certain aspects of auditor independence and the auditing profession's self-regulatory structure," and "focused on international developments affecting the auditing profession."[7]

In its 2000 report, the PAE noted, among many other things, that although auditors had been required to use the "audit risk model"[8] since 1984, "anecdotal and other evidence indicates that many (but by no means all) audits continued to be performed using substantive testing approaches with little or no attention paid to the results of the risk assessments called for by the model."[9] The PAE also noted, however, that over time, "[t]he sheer volume of transactions processed by client organizations, the fast pace of technological developments affecting client organizations and audit firms alike, and economic constraints on the ability of audit firms to recover rising costs" drove audit firms to evaluate audit effectiveness and efficiency, and to conclude that "many

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[3] AU sec. 319.

[4] Public Oversight Board, Panel on Audit Effectiveness, *Report and Recommendations*, p. 175 (August 31, 2000) ("PAE Report").

[5] Letter from Shaun O'Malley, Chair, PAE, to POB and other interested parties (August 31, 2000), included in PAE Report. The POB was a private body that monitored the self-regulatory programs of the SEC Practice Section of the American Institute of Certified Public Accountants ("AICPA"). See also, PAE Report, p.vii. The POB disbanded in 2002.

[6] PAE Report p.1.

[7] Ibid.

[8] The "audit risk model" describes the relationships among the different components of audit risk. See AU sec. 312.

[9] PAE Report, p. 178

PCAOB
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RELEASE

audits were being conducted without sufficient consideration being given to the risk assessment process."[10] According to the PAE Report, some firms responded to those developments by making changes to their audit methodologies.[11] Under newer audit methodologies, auditors take a more comprehensive approach to risk assessment, looking at internal and external factors that affect risks to the financial statements, and they focus their audit procedures on areas with the greatest risks of misstatement.[12]

The PAE concluded in its report "that the audit risk model is appropriate, but needs enhancing and updating," and it made several recommendations for doing so.[13] In general, the PAE recommended that auditing standards require auditors to have a far deeper understanding of the company's business processes, risks, and controls.[14] More specifically, it recommended, among other things, that auditors be required "to make inherent risk assessments for significant account balances and classes of transactions by considering what could go wrong at the individual assertion level,"[15] that the Auditing Standards Board of the AICPA ("ASB")[16] provide more specific guidance on various aspects of assessing and responding to control risk,[17] and that the ASB develop more

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[10] Ibid.

[11] Ibid.

[12] See, e.g., "Joint Working Group, Recommendations arising from a study of recent developments in the audit methodologies of the largest accounting firms" (May 2002). The Joint Working Group consisted of standard setters and academics from Canada, the United Kingdom and the United States. Its paper was prepared for submission to the International Auditing Practices Committee, the Assurance Standards Board of the Canadian Institute of Chartered Accountants, the Auditing Practices Board of the United Kingdom and Ireland and the Auditing Standards Board of the AICPA ("ASB").

[13] PAE Report, pp. 12-39. For a summary of the PAE's recommendations related to risk assessment, see PCAOB Standing Advisory Group Meeting Briefing Paper, "Risk Assessment in Financial Statement Audits" (February 16, 2005), Appendix E, available at http://www.pcaobus.org/News_and_Events/Events/2005/02-16.aspx.

[14] PAE Report, p 15.

[15] Ibid, p. 20.

[16] Prior to the Sarbanes-Oxley Act of 2002 ("the Act"), the ASB established standards for public company audits.

[17] PAE Report, pp. 28-29.

PCAOB
Public Company Accounting Oversight Board

RELEASE

guidance on "linking the nature, timing, and extent of substantive tests to risk assessments."[18]

In a February 2005 meeting, the SAG also considered how the risk assessment process and the Board's related interim standards could be improved. SAG members underscored the importance of considering the risk of fraud during the risk assessment process and of appropriately responding to that risk during the audit. Some SAG members suggested certain procedures for auditors to perform as part of their risk assessment procedures, including reading analysts' reports and other published information about the company being audited, listening to quarterly earnings calls, understanding the compensation arrangements of senior management, and looking at unusual trading activity in the company's stock. In addition, some SAG members emphasized the need for auditors to take an integrated approach to assessing and responding to risk in the integrated audit of the financial statements and internal control over financial reporting, which, at that time, was performed pursuant to Auditing Standard No. 2.

Last year, after notice and comment, the Board replaced Auditing Standard No. 2 with Auditing Standard No. 5.[19] Auditing Standard No. 5 describes a risk-based audit of internal control that should be fully integrated with the audit of financial statements. Some commenters on the Board's proposal for Auditing Standard No. 5 expressed concern about the advisability of taking a risk based approach and the adequacy of the Board's interim standards regarding risk assessment. These commenters suggested that auditors have frequently been unsuccessful at applying a risk-based approach to the financial statement audit in the past.[20]

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[18] Ibid, p. 37. In March 2006, the ASB issued a suite of eight risk assessment standards as part of a joint project with the International Audit and Assurance Standards Board ("IAASB") to update and align their risk assessment requirements. The Board's interim auditing standards consist of generally accepted auditing standards, as described in the ASB's Statement of Auditing Standards No. 95, as in existence on April 16, 2003, to the extent not superseded or amended by the Board. As a result, the ASB's 2006 risk assessment standards are not included in the Board's interim standards.

[19] Auditing Standard No. 5 became effective for audits of internal control over financial reporting for fiscal years ending on or after November 15, 2007.

[20] PCAOB Release No. 2007-005, An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements and Related Independence Rule and Conforming Amendments, (May 24, 2007) p. A4-6.

PCAOB
Public Company Accounting Oversight Board

RELEASE

The Board considered these comments, but believed that emphasizing risk assessment in the standard would result in more effective and focused audits.[21/] Accordingly, risk assessment underlies the entire audit process for the audit of internal control over financial reporting under Auditing Standard No. 5.[22/] While the Board believed (and continues to believe) that auditors can appropriately assess risk under the interim auditing standards, it noted when it adopted Auditing Standard No. 5 that examining the existing standards to see where improvements can be made was one of the Board's highest standard-setting priorities.

The proposed standards are the result of that examination and reflect recommendations of the PAE and the SAG. The Board believes that the proposed standards, if adopted, would result in improvements to audits of issuers in several areas.

First, the proposed standards would update the existing requirements to take account of the improved risk-based audit methodologies currently in use by some auditors. While some firms are already applying many of the procedures described in the proposed standards, the Board believes that improvements in risk assessment methods should be reflected in all public company audits. This does not mean, however, that the Board is proposing a one-size-fits-all approach to risk assessment. The Board recognized in Auditing Standard No. 5 that "[t]he size and complexity of the company…might affect the risks of misstatement and the controls necessary to address those risks."[23/] Accordingly, the proposed standards describe a risk assessment process that should result in audit procedures tailored to the company's size and complexity.

The proposed standards also reflect the Board's recognition of the importance to the audit process of sound professional judgment. As under the PCAOB's existing auditing standards, auditors would have to exercise professional judgment to determine how best to fulfill the requirements of the proposed standards under particular circumstances. The Board seeks comment on how the proposed standards would change current practice, whether the proposed standards allow sufficient flexibility, and whether they are appropriately scalable.

Second, the proposed standards would serve as an improved foundation for future standard setting. The proposed standards set forth the auditor's responsibilities for certain fundamental aspects of the audit process, such as assessing risk and performing tests of controls and substantive procedures. Future auditing standards that address auditing procedures would build on the foundational principles in the proposed

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21/ Ibid.

22/ Paragraph 10 of Auditing Standard No. 5.

23/ Paragraph 13 of Auditing Standard No. 5.

PCAOB
Public Company Accounting Oversight Board

RELEASE

standards. The Board seeks comment on whether these fundamental principles are articulated appropriately in the proposed standards.

Third, improvements in the requirements related to risk assessment should enhance integration of the audit of the financial statements with the audit of internal control over financial reporting. Because the proposed standards describe the auditor's responsibilities for assessing risk, responding to risk, and evaluating audit results in the context of an integrated audit of financial statements and internal control over financial reporting, they include certain foundational risk assessment principles from Auditing Standard No. 5. This should help auditors better understand how certain procedures required by Auditing Standard No. 5 can be integrated with financial statement audit procedures. The Board seeks comment on whether these fundamental principles from Auditing Standard No. 5 have been incorporated appropriately in the proposed standards, whether the proposed standards are appropriately aligned with Auditing Standard No. 5, and, accordingly, whether the proposed standards would improve the effectiveness and efficiency of integrated audits.[24/]

Fourth, the proposed auditing standards are intended to emphasize the auditor's responsibilities for considering the risk of fraud during the audit. Inspections of registered firms have identified many deficiencies in auditors' compliance with AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, including –

- a tendency to perform the procedures required in AU sec. 316 mechanically, without using the procedures to develop insights on fraud risk or modify the audit plan to address the risk; and

- a failure to respond appropriately to identified fraud risk factors.[25/]

These kinds of deficiencies suggest that some auditors may view the consideration of fraud as an isolated, mechanical process rather than an integral part of the audit.

[24/] The Board is not proposing changes to Auditing Standard No. 5, which was adopted last year after notice and comment and approved by the SEC. When considering provisions of the proposed standards that are based upon, or taken from, Auditing Standard No. 5, commenters should focus on whether those provisions are appropriately included in the risk assessment standards.

[25/] PCAOB Release 2007-001, "Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud" (January 22, 2007).

PCAOB
Public Company Accounting Oversight Board

RELEASE

The proposed standards would integrate certain requirements regarding the auditor's consideration of fraud risk, as set forth in AU sec. 316, into the risk assessment standards. This integration would emphasize to auditors that assessing the risk of fraud is a central part of the audit process, rather than a separate consideration. It also should prompt auditors to make a more thoughtful and thorough assessment of the risks affecting the financial statements, including fraud risks, and develop appropriate audit responses. The Board seeks comment on whether the proposed standards focus appropriately on the risk of fraud.

Finally, the proposed standards reflect an effort to eliminate unnecessary differences between the Board's risk assessment standards and other risk assessment standards. The Board believes that such an effort is particularly appropriate in light of the foundational nature of these proposed standards. This effort is in keeping with the Board's strategic plan for 2008-2013, which states the Board's objective to "[p]articipate in the work of, and engage with, other auditing standards-setting bodies to benefit from, and as appropriate incorporate, new developments and techniques to promote high quality audits worldwide."[26/]

In recent years, the IAASB has updated its auditing standards regarding risk assessment.[27/] The Board has taken into account the IAASB risk assessment standards in developing these proposals. Specifically, the Board began by considering whether the objectives and requirements of the IAASB's standards are appropriate for audits of issuers and consistent with the Board's statutory mandate "to oversee the audit of public companies that are subject to the securities laws…in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."[28/] While many of the procedures described in the IAASB standards appear to be generally suitable for audits of issuers, the Board believes that certain changes to those standards would be necessary for the Board to adopt them as standards of the PCAOB. Accordingly, there is a degree of commonality between the proposed standards and the IAASB's risk assessment standards, but they do not mirror them word-for-word.

26/ PCAOB, Strategic Plan 17 (March 31, 2008), p.17.

27/ The IAASB issued its initial risk assessment standards in 2003 and has updated four of its standards related to risk assessment as part of its initiative to enhance the clarity of its standards. The Board understands that the ASB is in the process of a similar initiative.

28/ Section 101 of the Sarbanes-Oxley Act of 2002 (the "Act"), 15 U.S.C. § 7211.

PCAOB
Public Company Accounting Oversight Board

RELEASE

Significant differences between the proposed standards and the IAASB's risk assessment standards are described in Appendix 10. As described more fully in that appendix, these differences generally reflect the need to adapt the IAASB standards for audits of issuers. For example, the Board made changes necessary to make the proposed standards consistent with relevant provisions of the federal securities laws. In addition, consistent with other PCAOB standards, the proposed standards do not include an "Application and Other Explanatory Material" section. That section, included in the IAASB's redrafted International Standards on Auditing ("ISAs"), "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA."[29/] Rather than including a significant amount of application material in the proposed standards, the Board reviewed the application and other material in the ISAs, adapted those provisions that the Board believed are necessary for audits of issuers, and included them in the proposed standards themselves. Like the rest of the provisions in the proposed standards, the provisions adapted from the ISAs' application material use the terms set forth in Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards,* to describe the degree of responsibility imposed on the auditor. The Board also adapted other portions of the ISAs to conform the requirements to the provisions of Rule 3101. Finally, some differences reflect the Board's view that particular procedures described in the ISAs are not necessary for audits of issuers, or that additional procedures not described in the ISAs are necessary.

The Board seeks comment on whether the proposed standards appropriately consider the provisions of the ISAs and whether they reflect necessary differences from risk assessment standards applicable outside the United States.

B. Overview of the Proposed Standards

The proposed risk assessment standards included in this release are as follows:

- *Audit Risk in an Audit of Financial Statements.* This proposed standard describes the components of audit risk and the auditor's responsibilities for reducing audit risk to an appropriately low level in order to obtain reasonable assurance in an audit of financial statements.

- *Audit Planning and Supervision.* This proposed standard describes the auditor's responsibilities for planning the audit, including assessing matters that are important to the audit, and establishing an appropriate audit strategy and audit plan. The proposed standard also describes the

[29/] Paragraph A59 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.*

RELEASE

responsibilities of the engagement partner and other engagement team members for supervising and reviewing the work of the engagement team.

- *Identifying and Assessing Risks of Material Misstatement.* This proposed standard describes the auditor's responsibilities for identifying and assessing risks of material misstatement. The risk assessment process discussed in the proposed standard includes information-gathering procedures to identify risks (e.g., obtaining an understanding of the company, its environment, and its internal control) and analysis of the identified risks.

- *The Auditor's Responses to the Risks of Material Misstatement.* This proposed standard sets forth the auditor's responsibilities for responding to the risks of material misstatement, including overall responses related to the general conduct of the audit and responses involving specific audit procedures.

- *Evaluating Audit Results.* This proposed standard describes the auditor's responsibilities regarding the process of evaluating the results of the audit in order to form the opinion(s) to be presented in the auditor's report. This process includes evaluating uncorrected misstatements and control deficiencies identified during the audit.

- *Consideration of Materiality in Planning and Performing an Audit.* This proposed standard sets forth the auditor's responsibilities for applying the concept of materiality, as described by the federal securities laws, in planning the audit and determining the scope of the audit procedures.

- *Audit Evidence.* This proposed standard sets forth the auditor's responsibilities regarding designing and applying audit procedures to obtain sufficient appropriate evidence to support the opinion(s) in the auditor's report. In particular, it discusses the principles for determining the sufficiency and appropriateness of audit evidence.

The proposed standards will supersede five interim auditing standards: AU sec. 311, *Planning and Supervision,* AU sec. 312, *Audit Risk and Materiality in Conducting an Audit,* AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date,* AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit,* and AU sec. 326, *Evidential Matter.*

Appendix 9 of this release discusses each of the proposed standards, as well as the proposed conforming amendments to PCAOB standards, in more detail. Appendix 9

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Public Company Accounting Oversight Board

RELEASE

also includes specific questions about the standards for which the Board is requesting comment. The Board requests comment on all aspects of the proposed standards and the conforming amendments to PCAOB interim standards, including, in particular, responses to the questions in Appendix 9.

C. Opportunity for Public Comment

The Board will seek comment on the proposed standards and amendments for a 120-day period. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, DC 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 026 on the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on February 18, 2009.

* * *

On the 21st day of October, in the year 2008, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Secretary

October 21, 2008

PCAOB
Public Company Accounting Oversight Board

RELEASE

APPENDICES –

1. *Proposed Auditing Standard – Audit Risk in an Audit of Financial Statements*

2. *Proposed Auditing Standard – Audit Planning and Supervision*

3. *Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement*

4. *Proposed Auditing Standard – The Auditor's Responses to the Risks of Material Misstatement*

5. *Proposed Auditing Standard – Evaluating Audit Results*

6. *Proposed Auditing Standard – Consideration of Materiality in Planning and Performing an Audit*

7. *Proposed Auditing Standard – Audit Evidence*

8. *Proposed Conforming Amendments to PCAOB Standards*

9. *Additional Discussion of Proposed Auditing Standards and Conforming Amendments*

10. *Comparison of Requirements to the Standards of the International Auditing and Assurance Standards Board*

PCAOB
Public Company Accounting Oversight Board

RELEASE

APPENDIX 1 – PROPOSED AUDITING STANDARD

October 21, 2008
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

Audit Risk in an Audit of Financial Statements

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Audit Risk in an Audit of Financial Statements

Introduction

1. This standard establishes requirements and provides direction regarding the auditor's consideration of audit risk in an audit of financial statements.[1/]

> Note: Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* establishes requirements and provides direction regarding the auditor's consideration of risk in an audit of internal control over financial reporting.

Objective of the Auditor

2. The objective of the auditor is to conduct the audit of the financial statements in a manner that reduces audit risk to an appropriately low level.

Audit Risk

3. To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care and obtaining sufficient appropriate audit evidence.[2/]

4. In an audit of financial statements, audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. This risk is a function of the risk of material misstatement and detection risk.

[1/] An audit of financial statements refers to an audit of financial statements as part of an integrated audit and to an audit of financial statements only.

[2/] See AU sec. 110, *Responsibilities and Functions of the Independent Auditor,* and AU sec. 230, *Due Professional Care in the Performance of Work,* for a further discussion of reasonable assurance.

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Risk of Material Misstatement

5. The risk of material misstatement refers to the risk that the financial statements are materially misstated due to error or fraud. Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* indicates that the auditor should assess the risks of material misstatement at two levels: at the overall financial statement level and at the financial statement assertion[3/] level.

6. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

7. The risks of material misstatement at the assertion level consist of the following components:

   a. *Inherent risk,* which refers to the susceptibility of an assertion to a misstatement, due to error or fraud, that could be material, either individually or in combination with other misstatements, before consideration of any related controls.

   b. *Control risk,* which is the risk that a misstatement due to error or fraud that could occur in an assertion and that could be material, either individually or in combination with other misstatements, will not be prevented or detected on a timely basis by the company's internal control. Control risk is a function of the effectiveness of the design and operation of internal control.

8. Inherent risk and control risk are the company's risks; they exist independently of the audit.

Detection Risk

9. In the audit of the financial statements, detection risk is the risk that the procedures performed by the auditor will not detect a misstatement that exists and that could be material, either individually or in combination with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor.

[3/] See Proposed Auditing Standard, *Audit Evidence,* for a description of financial statement assertions.

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10. The level of detection risk is reduced through the performance of substantive procedures. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the risk of material misstatement at the assertion level. The greater the risk of material misstatement, the less the detection risk that can be accepted. Conversely, the lower the risk of material misstatement, the greater the detection risk that can be accepted.

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APPENDIX 2 – PROPOSED AUDITING STANDARD – AUDIT PLANNING AND SUPERVISION

October 21, 2008
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

Audit Planning and Supervision

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Audit Planning and Supervision

Introduction

1. This standard establishes requirements and provides direction regarding planning an audit and supervising the work of engagement team members.

Objective of the Auditor

2. The objective of the auditor is to plan the audit and supervise the engagement team so that the audit is conducted effectively.

3. Accordingly, the auditor must adequately plan the audit and properly supervise the members of the engagement team.

Planning an Audit

4. Planning an audit includes establishing the overall audit strategy for the engagement and developing an audit plan, which includes, in particular, planned risk assessment procedures and planned responses to the risks of material misstatement. Planning is not a discrete phase of an audit, but rather a continual and iterative process that might begin shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.

Involvement of Key Engagement Team Members in Planning

5. The engagement partner[1/] is responsible for planning the engagement but may seek assistance from other members of the engagement team.

Preliminary Engagement Activities

6. The auditor should perform the following activities at the beginning of the audit:

   a. Perform procedures regarding the continuance of the client relationship and the specific audit engagement;[2/]

[1/] The term, "engagement partner" refers to the member of the audit engagement team with final responsibility for the audit.

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b. Determine compliance with independence and ethics requirements; and

c. Establish an understanding with the client regarding the services to be performed on the engagement.[3/]

Note: The decision regarding continuance of the client relationship and determination of compliance are not limited to preliminary engagement activities and could change with changes in circumstances.

Planning Activities

7. The nature and extent of planning activities that are necessary depend on the size and complexity of the company, the auditor's previous experience with the company, and changes in circumstances that occur during the audit. When developing the audit strategy and audit plan as discussed in paragraphs 8-10, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures:

- Knowledge of the company's internal control over financial reporting or other information relevant to identifying risks of material misstatement obtained during other engagements performed by the auditor;
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;

[2/] See paragraphs .14-.16 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice.* AU sec. 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* explains how the quality control standards relate to the conduct of audits.

[3/] AU sec. 310, *Appointment of the Independent Auditor.*

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- The auditor's preliminary judgments about materiality,[4/] risk, and other factors relating to the determination of material misstatements and material weaknesses;
- Control deficiencies previously communicated to the audit committee or management;
- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;
- Preliminary judgments about the effectiveness of internal control over financial reporting;
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;
- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and
- The relative complexity of the company's operations.

Audit Strategy

8. The auditor should establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

9. In establishing the overall audit strategy, the auditor should:

   a. Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required by PCAOB standards

   b. Determine the significant factors that affect the direction of the engagement team

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[4/] Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit.*

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c. Determine the effects on the audit strategy of the results of preliminary engagement activities and the auditor's evaluation of the important matters in accordance with paragraph 7 of this standard, and

d. Ascertain the nature, timing and extent of resources necessary to perform the engagement.

Audit Plan

10. The auditor should develop a written audit plan that should include a description of:

a. The planned nature, timing and extent of the risk assessment procedures.[5/]

b. The planned nature, timing and extent of tests of controls and substantive procedures.[6/]

c. Other planned audit procedures that are required to be carried out so that the engagement complies with PCAOB standards.

Multi-location Engagements

11. In an audit of the financial statements of a company with operations in multiple locations or business units, the auditor should determine the extent to which auditing procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The factors an auditor should evaluate regarding the selection of a particular location or business unit include:

a. The nature and amount of assets, liabilities, and transactions executed at the location or business unit,

b. The materiality of the location or business unit,

[5/] Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement.*

[6/] Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, and Auditing Standard No. 5.

c. The risk of material misstatement to the financial statements associated with the location or business unit,

d. The degree of centralization of records or information processing,

e. The effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or business unit, and

f. The frequency, timing, and scope of monitoring activities by the company or others at the location or business unit.

> Note: When performing an audit of internal control over financial reporting, refer to paragraphs B10-B16 of Appendix B, Special Topics, of PCAOB Auditing Standard No. 5, for considerations when a company has multiple locations or business units.

Changes During the Course of the Audit

12. The auditor should update and change the overall audit strategy and the audit plan as necessary if circumstances change significantly during the course of the audit, e.g., based on a revised assessment of the risks of material misstatement or the discovery of a previously unidentified fraud risk.

Individuals with Specialized Skill or Knowledge

13. The auditor should determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, apply the planned audit procedures, or evaluate audit results.

14. In particular, the auditor should determine whether specialized skill or knowledge is needed to evaluate the effect of information technology ("IT") on the audit, to understand the IT controls, or to design and perform tests of IT controls or substantive procedures. Factors that may be relevant to the auditor's determination of the need for specialized IT skills or knowledge include the following:

- The complexity of the company's systems and IT controls and the manner in which they are used in conducting the company's business

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- The significance of changes made to existing systems or the implementation of new systems
- The extent to which data is shared among systems
- The extent of the company's participation in electronic commerce
- The company's use of emerging technologies
- The significance of audit evidence that is available only in electronic form

15. If an individual with specialized IT skill or knowledge employed or engaged by the auditor's firm participates in the audit, the auditor should have sufficient IT-related knowledge to enable the auditor to:

    a. Communicate the objectives of that individual's work;

    b. Evaluate whether that individual's procedures meet the auditor's objectives; and

    c. Evaluate the results of that individual's procedures as they relate to the nature, timing, and extent of other planned audit procedures.[7/]

Additional Considerations in Initial Audits

16. The auditor should undertake the following activities before starting an initial audit:

    a. Perform procedures regarding the acceptance of the client relationship and the specific audit engagement; and

    b. Communicate with the predecessor auditor, in situations in which there has been a change of auditors, in accordance with AU sec. 315, *Communications Between Predecessor and Successor Auditors.*

[7/] Using the work of a specialist who is, in effect, functioning as a member of the engagement team is not covered by AU sec. 336, *Using the Work of a Specialist.* An individual with specialized IT skill or knowledge requires the same supervision as any member of the engagement team.

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17. The purpose and objective of planning the audit are the same whether the engagement is an initial audit or a recurring audit engagement. However, for an initial audit, the auditor should determine whether it is necessary to expand the planning activities to establish an appropriate audit strategy and audit plan, e.g., to determine the audit procedures necessary to obtain sufficient appropriate audit evidence regarding the opening balances.

Supervision

18. The engagement partner should supervise other engagement team members, but he or she may seek assistance from appropriate engagement team members in fulfilling these supervisory responsibilities.

19. Supervision should include the following:

    a. Informing other engagement team members of their responsibilities and the objectives of the procedures that they are to perform, and other matters that could affect the nature, timing, and extent of procedures they are to perform or the evaluation of the results of those procedures, such as the nature of the company's business as it relates to their assignments and possible accounting and auditing issues;

    b. Directing other engagement team members to bring significant accounting and auditing issues arising during the audit to the engagement partner's attention so those issues can be assessed and appropriate actions can be taken; and

    c. Reviewing the work of other engagement team members to determine whether the work was performed and documented and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report.

20. The level of supervision of other engagement team members should be appropriate for the circumstances, including:

    - The size and complexity of the company

    - The nature of the assigned work for each team member, including the procedures to be performed and the controls or accounts and disclosures to be tested

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- The risks of material misstatement[8/]

- The capabilities and competence of the individual team members performing the audit work

21. The engagement partner and other engagement team members should make themselves aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among the engagement team members. Such procedures should enable an engagement team member to document his or her disagreement with the conclusions reached in the resolution of the matter. In this situation, the basis for the final resolution also should be documented.[9/]

[8/] Paragraph 4b of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement,* indicates that the level of supervision of engagement team members is part of the auditor's overall responses to the risks of material misstatement.

[9/] See also paragraph 12d of Auditing Standard No. 3, *Audit Documentation.*

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APPENDIX 3 – PROPOSED AUDITING STANDARD

October 21, 2008
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

Identifying and Assessing Risks of Material Misstatement

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Identifying and Assessing Risks of Material Misstatement

Introduction

1. This standard establishes requirements and provides direction regarding the process of identifying and assessing risks of material misstatement[1/] of the financial statements.

2. Paragraphs 5-55 describe risk assessment procedures for obtaining information necessary to identify and assess risks of material misstatement. Paragraphs 56-64 explain how to identify and assess the risks of material misstatement using information obtained from the risk assessment procedures.

Objective of the Auditor

3. The objective of the auditor is to identify and appropriately assess the risks of material misstatement.

Definitions

4. For purposes of this standard, the terms listed below are defined as follows:

   a. Risk assessment procedures – The procedures performed by the auditor to obtain information for identifying and assessing the risks of material misstatement in the financial statements.[2/]

   b. Significant risk – A risk of material misstatement that is important enough to require special audit consideration.

[1/] Paragraphs 5-8 of Proposed Auditing Standard, *Audit Risk in an Audit of Financial Statements.*

[2/] Risk assessment procedures by themselves do not provide sufficient appropriate evidence on which to base an audit opinion.

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Performing Risk Assessment Procedures

5. The auditor should perform risk assessment procedures to obtain sufficient appropriate evidence to identify and appropriately assess the risks of material misstatement due to error or fraud[3/] and to design further audit procedures.[4/]

6. The auditor's risk assessment procedures should include the following:

   a. Obtaining an understanding of the company and its environment;

   b. Obtaining an understanding of internal control over financial reporting;[5/]

   c. Considering information from the client acceptance and retention evaluation, past audits, and other engagements;

   d. Performing analytical procedures;

   e. Conducting a discussion among engagement team members regarding the risks of material misstatement; and

   f. Inquiring of the audit committee, management, and others within the company about the risks of material misstatement.

7. In an integrated audit, the risks of material misstatement of the financial statements are the same for both the audit of internal control over financial reporting and the audit of the financial statements. Accordingly, the auditor's risk assessment procedures should apply to both the audit of internal control over financial reporting and the audit of the financial statements.

[3/] AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, discusses fraud, its characteristics, and the types of misstatements due to fraud that are relevant to the audit, i.e., misstatements arising from fraudulent financial reporting and misstatements arising from asset misappropriation.

[4/] Proposed Auditing Standard, *Audit Evidence*, defines further audit procedures as tests of controls and substantive procedures.

[5/] See A5 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements,* for a definition of "internal control over financial reporting" and a discussion of the inherent limitations of internal control over financial reporting.

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Obtaining an Understanding of the Company and Its Environment

8. The auditor should obtain an understanding of the company and its environment ("understanding of the company") to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement.

9. The auditor's understanding of the company should include the following:

   a. Relevant industry, regulatory, and other external factors;

   b. The nature of the company;

   c. The company's objectives and strategies and those related business risks that might reasonably be expected to result in risks of material misstatement;

   d. The company's measurement and review of its financial performance; and

   e. The company's selection and application of accounting policies, including the reasons for changes thereto.

10. While obtaining an understanding of the company, the auditor should evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.

Industry, Regulatory, and Other External Factors

11. Industry, regulatory, and other external factors that are relevant to the auditor's understanding of the company include industry factors such as the competitive environment and technological developments; the regulatory environment, including the applicable financial reporting framework[6/] and the legal and political environment;[7/] and other external factors such as general economic conditions.

[6/] The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

[7/] See AU sec. 317, *Illegal Acts by Clients*, for additional direction regarding the auditor's consideration of laws and regulations relevant to the audit.

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Nature of the Company

12. Obtaining an understanding of the nature of the company includes obtaining an understanding of the following:

- The company's organizational structure and management personnel;
- The sources of funding of the company's operations and investment activities, including the company's capital structure, non-capital funding (e.g., subordinated debt or dependencies on supplier financing), and other debt instruments;
- The company's investments;
- The company's operating characteristics, including its size and complexity;[8/]
- The sources of the company's earnings, including the relative profitability of key products and services; and
- Key supplier and customer relationships.

  Note: The auditor should take into account the information obtained while obtaining an understanding of the nature of the company when determining the existence of related parties, in accordance with AU sec. 334, *Related Parties.*

13. The auditor also should consider performing the following procedures as part of obtaining an understanding of the company:

- Reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;[9/]
- Observing or reading transcripts of earnings calls;

8/ The size and complexity of a company might affect the risks of misstatement and how the company addresses those risks. The note to paragraph 9 of Auditing Standard No. 5 discusses factors that might indicate less complex operations.

9/ Paragraph 7 of Proposed Auditing Standard, *Audit Planning and Supervision.*

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- Obtaining information about significant unusual developments regarding trading activity in the company's securities; and
- Obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements; changes or adjustments to those arrangements and special bonuses.

Company Objectives, Strategies, and Related Business Risks

14. The purpose of obtaining an understanding of the company's objectives, strategies,[10/] and related business risks[11/] is to identify those business risks that could reasonably be expected to result in material misstatement of the financial statements.

15. The following are examples of business risks that might be relevant to the auditor's consideration of the company's, strategies and related business risks –

- Industry developments (a potential related business risk might be, for example, that the company does not have the personnel or expertise to deal with the changes in the industry).
- New products and services (a potential related business risk might be, for example, that the new product or service will not be successful).
- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).
- Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).

10/ For purposes of this standard, objectives refer to the overall plans for the company as established by management or the board of directors. Strategies are the approaches by which management intends to achieve its objectives.

11/ Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect a company's ability to achieve its objectives and execute its strategies. Business risks also might result from setting inappropriate objectives and strategies or from change or complexity in the company's operations or management.

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- Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the company's inability to meet requirements).

- Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).

- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

  Note: Some relevant business risks might be identified through other risk assessment procedures, such as obtaining an understanding of the nature of the company and understanding industry, regulatory, and other external factors.

Company Performance Measures

16. The purpose of obtaining an understanding of the company's performance measures is to identify those performance measures, whether external or internal, that affect the risks of material misstatement.

17. The following are examples of performance measures that might affect the risks of material misstatement:

- Measures that form the basis for contractual commitments or incentive compensation arrangements

- Measures the company uses to monitor its operations when such monitoring procedures (a) are sufficiently precise to prevent or detect misstatements that could result in material misstatement of the financial statements and (b) have effective controls over the accuracy of the measures

  Note: Smaller companies might have less formal processes to measure and review financial performance. In such cases, the auditor might identify relevant performance measures by considering the information that the company uses to manage the business.

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Selection and Application of Accounting Principles

18. As part of obtaining an understanding of the company's selection and application of accounting principles, the auditor should evaluate whether the company's selection and application of accounting principles is appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the relevant industry.

19. The auditor should obtain an understanding of the following matters, if applicable, in obtaining an understanding of the company's selection and application of accounting principles:

- The methods the company uses to account for significant and unusual transactions
- The accounts or disclosures in which judgment is used in the application of significant accounting principles, especially those used for determining management's estimates and assumptions
- The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus
- The degree of transparency of the application of significant accounting principles and related financial reporting processes
- Significant changes in the company's accounting and financial reporting policies and disclosures and the reasons for such changes
- Financial reporting standards and laws and regulations that are new to the company and when and how the company will adopt such requirements
- The financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles

Obtaining an Understanding of Internal Control Over Financial Reporting

20. The auditor should obtain a sufficient understanding of each component of internal control over financial reporting ("understanding of internal control") to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.

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21. The nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company;[12/] the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the company's use of information technology the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting.

    Note: The auditor also might obtain an understanding of certain controls that are not part of internal control over financial reporting. For example, if the auditor plans to use information produced by the company, he or she should obtain an understanding of controls over the completeness and accuracy of that information if necessary to evaluate the sufficiency and appropriateness of the information.[13/]

22. In obtaining an understanding of internal control, the auditor should evaluate the design of controls and determine whether the controls have been implemented.

    Note: In evaluating the design of controls, the auditor should apply the direction provided in paragraphs 21-22 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement.*

    Note: Determining whether a control has been implemented means determining whether the control exists and whether the company is using it. The procedures to determine whether a control has been implemented may be performed in connection with the evaluation of its design. Procedures performed to determine whether a control has been implemented include inquiry of company personnel in combination with observation of the application of controls or inspection of documentation.

12/ Paragraph 13 of Auditing Standard No. 5 states, "The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its control objectives. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks."

13/ Paragraph 10 of Proposed Auditing Standard, *Audit Evidence.*

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Components of Internal Control Over Financial Reporting

23. Internal control over financial reporting can be described as consisting of the following components:[14/]

- The control environment
- The company's risk assessment process
- The information system relevant to financial reporting and communication
- Control activities
- Monitoring of controls

24. In an audit of financial statements only, the auditor may use an internal control framework with components that are different from the components identified in the preceding paragraph provided the framework is a suitable, recognized framework.[15/] Paragraph 5 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements,* states that, in an integrated audit:

> The auditor should use the same suitable, recognized control framework to perform the audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting.[16/]

If the auditor uses a suitable, recognized internal control framework with components that differ from those listed in the preceding paragraph, the auditor should adapt the requirements in paragraphs 25 - 36 of this standard to conform to the components in the framework used.

[14/] Different internal control frameworks use different terms and approaches to describe the components of internal control over financial reporting.

[15/] See Securities Exchange Act Release No. 34-47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

[16/] Footnote 7 of Auditing Standard No. 5.

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Control Environment

25. The auditor should obtain an understanding of the company's control environment, including the policies and actions of management, the board, and the audit committee concerning the company's control environment.

Note: In an integrated audit, the auditor's procedures for obtaining an understanding of the control environment might be performed as part of the evaluation of entity-level controls, as discussed in paragraphs 22-24 of Auditing Standard No. 5.

26. While obtaining an understanding of the control environment, the auditor should assess –

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

Note: In an audit of financial statements only, this assessment may be based on the evidence obtained in understanding the control environment, in accordance with paragraph 25, and the other relevant knowledge possessed by the auditor. In an integrated audit of financial statements and internal control over financial reporting, paragraph 25 of Auditing Standard No. 5 describes the auditor's responsibility for evaluating the control environment.

27. If the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor as discussed in paragraphs 58-60.

The Company's Risk Assessment Process

28. The auditor should obtain an understanding of management's process for:

a. Identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud ("fraud risks"),

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b. Assessing the likelihood and significance of misstatements resulting from those risks, and

c. Deciding about actions to address those risks.

Note: In an integrated audit, the auditor's procedures for obtaining an understanding of the company's risk assessment process might be performed in conjunction with the evaluation of entity-level controls, as discussed in paragraphs 22-24 of Auditing Standard No. 5.

Information System Relevant to Financial Reporting and Communication

29. *Information System Relevant to Financial Reporting.* The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following:

a. The classes of transactions in the company's operations that are significant to the financial statements;

b. The procedures, within both IT and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported;

c. The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions;

d. How the information system captures events and conditions, other than transactions,[17/] that are significant to the financial statements; and

e. The period-end financial reporting process.

30. *Business Processes.* A company's business processes are the activities designed to:

a. Develop, purchase, produce, sell and distribute a company's products and services;

[17/] Examples of such events and conditions include depreciation and amortization and conditions affecting the recoverability of assets.

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b. Ensure compliance with laws and regulations relevant to the financial statements; and

c. Record information, including accounting and financial reporting information.

31. Business processes result in the transactions that are recorded, processed and reported by the information system. Obtaining an understanding of the company's business processes, which include how transactions are originated, assists the auditor in obtaining an understanding of the company's information system relevant to financial reporting in a manner that is appropriate to the company's circumstances.

32. *Period-end Financial Reporting Process.* The company's period-end financial reporting process, as referred to in paragraph 29e, includes the following:

- Procedures used to enter transaction totals into the general ledger;
- Procedures related to the selection and application of accounting policies;[18/]
- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- Procedures used to record recurring and nonrecurring adjustments to the annual financial statements (and quarterly financial statements, if the audit is an integrated audit); and
- Procedures for preparing annual financial statements and related disclosures (and quarterly financial statements, if the audit is an integrated audit).

Note: In an integrated audit, the auditor's procedures for obtaining an understanding of the company's monitoring activities might be performed in conjunction with the evaluation of entity-level controls, as discussed in paragraphs 26-27 of Auditing Standard No. 5.

[18/] See paragraphs 18-19 of this standard.

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33. *Communication.* The auditor should obtain an understanding of how the company communicates financial reporting roles and responsibilities and significant matters relating to financial reporting including –

- Communications between management, the audit committee and the board;
- Communications to external parties, including regulatory authorities and shareholders.

  Note: In an integrated audit, the auditor's procedures for obtaining an understanding of how the company communicates financial reporting roles and responsibilities and significant matters relating to financial reporting might be performed in conjunction with the evaluation of entity-level controls, as discussed in paragraphs 22-24 of Auditing Standard No. 5.

Control Activities

34. The auditor should obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures, as described in paragraph 20.

  Note: For purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than that which is normally obtained in an audit of financial statements only.

Monitoring of Controls

35. The auditor should obtain an understanding of the types of major activities that the company uses to monitor the effectiveness of its internal control over financial reporting and how the company initiates corrective actions related to its controls.

  Note: In an integrated audit, the auditor's procedures for obtaining an understanding of the company's monitoring activities might be performed in conjunction with the evaluation of entity-level controls, as discussed in paragraphs 22-24 of Auditing Standard No. 5.

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36. An understanding of the company's monitoring activities[19] should include understanding the source of the information used in the monitoring activities.

Considering Information from the Client Acceptance and Retention Evaluation, Past Audits, and Other Engagements

37. *Client Acceptance and Retention and Audit Planning Activities.* The auditor should evaluate whether information obtained from the client acceptance and retention process or audit planning activities is relevant to identifying risks of material misstatement. Risks of material misstatement identified during those activities should be assessed as discussed in paragraphs 56-63 of this standard.

38. *Past Audits.* In subsequent years, the auditor should incorporate knowledge obtained during past audits into the auditor's process for identifying risks of material misstatement e.g., in determining how changes in the company or its environment affect the risks of material misstatement, as discussed in paragraph 10 of this standard.

39. If the auditor plans to modify the nature, timing, or extent of his or her risk assessment procedures based on information from past audits, the auditor should determine that the prior-year's information is relevant.

40. *Other Engagements.* When the auditor has performed a review of interim financial information in accordance with AU sec. 722, *Interim Financial Information,* the auditor should evaluate whether information obtained during the review is relevant to identifying risks of material misstatement in the year-end audit.

41. The auditor should assess whether information obtained in other engagements performed by the auditor is likely to be important for identifying risks of material misstatement.[20]

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[19] AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* describes the auditor's responsibilities regarding obtaining an understanding of a company's monitoring activities involving the company's internal audit function.

[20] See paragraph 7 of Proposed Auditing Standard, *Audit Planning and Supervision.*

Note: In multi-location engagements in which certain components are audited by affiliated firms, this might be accomplished through communications between the engagement partner and those responsible for the audits of components.

Performing Analytical Procedures

42. The auditor should perform analytical procedures that are designed to:

    a. Enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the last audit date; and

    b. Identify areas that might represent specific risks relevant to the audit, such as, the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.

43. In applying analytical procedures as risk assessment procedures, the auditor should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement due to fraud. Also, when the auditor has performed a review of interim financial information in accordance with AU sec. 722, *Interim Financial Information*, he or she should take into account the analytical procedures applied in that review when designing and applying analytical procedures as risk assessment procedures.

44. When applying an analytical procedure, the auditor should use his or her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure.[21/] When comparison of those expectations with relationships derived from recorded amounts yields unusual or unexpected results, the auditor should take into account those results in identifying the risks of material misstatement.

Conducting a Discussion among Engagement Team Members Regarding Risks of Material Misstatement

45. The key engagement team members should discuss (1) the susceptibility of the company's financial statements to material misstatement due to error or fraud

21/ Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

Public Company Accounting Oversight Board

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and (2) the application of the applicable financial reporting framework to the company's facts and circumstances.

> Note: The key engagement team members should discuss the potential for material misstatement due to fraud either as part of the discussion regarding risks of material misstatement or in a separate discussion. See paragraphs 48-49 of this standard.

46. Key engagement team members include all engagement team members who have significant engagement responsibilities, including the engagement partner. The manner in which the discussion may be conducted depends on the individuals involved and the circumstances of the engagement. For example, if the audit involves more than one location, there could be multiple discussions with team members in differing locations. The engagement partner or other key engagement team members should communicate the important matters from the discussion to engagement team members who are not involved in the discussion.

> Note: If the audit is performed entirely by the engagement partner, that engagement partner, having personally conducted the planning of the audit, is responsible for considering the susceptibility of the company's financial statements to material misstatement.

47. Communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit when conditions change.[22/]

Discussion of the Potential for Material Misstatement Due to Fraud

48. The discussion among the engagement team members about the potential for material misstatement due to fraud should occur with an attitude that includes a questioning mind, and the engagement team members should set aside any prior beliefs they might have that management is honest and has integrity. The discussion among the engagement team members should include –

- An exchange of ideas or "brainstorming" among the engagement team members, including the engagement partner, about how and where they believe the company's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate

[22/] See also paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results*.

and conceal fraudulent financial reporting, and how assets of the company could be misappropriated

- A consideration of the known external and internal factors affecting the company that might (a) create incentives or pressures for management and others to commit fraud, (b) provide the opportunity for fraud to be perpetrated, and (c) indicate a culture or environment that enables management to rationalize committing fraud

- A consideration of the risk of management override

- Communication about the potential audit responses to the susceptibility of the company's financial statements to material misstatement due to fraud

49. The following matters should be emphasized to all engagement team members:

- The need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, as described in AU sec. 316.13

- The need to be alert for information or other conditions (such as those presented in paragraph B1 of Proposed Auditing Standard*, Evaluating Audit Results*) that might affect the assessment of fraud risks

- If information or other conditions indicate a material misstatement due to fraud might have occurred, the need to probe the issues, acquire additional evidence as necessary, and consult with other team members and, if appropriate, others in the firm including specialists

Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

50. The auditor should make inquiries of the audit committee (or its chair), management, the internal audit function, and others within the company who might reasonably be expected to have information that is important to the identification and assessment of risks of material misstatement.

    Note: The auditor's inquiries about risks of material misstatement should include inquiries regarding fraud risks.

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RELEASE

51. The auditor should use his or her knowledge of the company and its environment as well as information from other risk assessment procedures to determine the nature of those inquiries.

Inquiries Regarding Fraud Risks

52. The auditor's inquiries regarding fraud risks should include the following:

a. Inquiries of management regarding:

(1) Whether management has knowledge of fraud, alleged fraud or suspected fraud affecting the company;

(2) Management's process for identifying and responding to the risks of fraud in the company, including any specific fraud risks the company has identified or account balances or disclosures for which a fraud risk is likely to exist, and the nature, extent, and frequency of management's fraud risk assessment process;

(3) Controls that the company has established to address fraud risks the company has identified, or that otherwise help to prevent and detect fraud, including how management monitors those controls;

(4) For a company with multiple locations (a) the nature and extent of monitoring of operating locations or business segments and (b) whether there are particular operating locations or business segments for which a risk of fraud might be more likely to exist;

(5) Whether and how management communicates to employees its views on business practices and ethical behavior; and

(6) Whether management has reported to the audit committee on how the company's internal control serves to prevent and detect material misstatements due to fraud.

b. Inquiries of the audit committee or its chair regarding:

(1) The audit committee's views about the risks of fraud;

(2) Whether the audit committee has knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

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(3) How the audit committee exercises oversight of the company's assessment of the risks of fraud; and

(4) If the audit committee assumes an active role in the oversight of the company's assessment of fraud risks and mitigating controls, the audit committee's views regarding fraud risks and the mitigating controls.

c. If the company has an internal audit function, inquiries of appropriate internal audit personnel regarding:

(1) The internal auditors' views about the risks of fraud;

(2) Whether the internal auditors have knowledge of fraud, alleged fraud, or suspected fraud affecting the company; and

(3) Whether internal auditors have performed procedures to identify or detect fraud during the year, and whether management has satisfactorily responded to the findings resulting from those procedures.

d. Inquiries of accounting and financial reporting personnel, including, in particular, employees involved in initiating, authorizing, processing, or recording complex or unusual transactions regarding–

(1) The employee's views as to whether accounting policies were appropriately or aggressively applied;

(2) The employee's views about the risks of fraud;

(3) Whether the employee has knowledge of fraud, alleged fraud, or suspected fraud affecting the company; and

(4) Whether the employee is aware of instances of management override of controls and the nature and circumstances of such overrides.

53. In addition to the inquiries outlined in the preceding paragraph, the auditor should inquire of others within the company about whether they have knowledge of fraud, alleged fraud, or suspected fraud.

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54. In determining the individuals within the company to whom inquiries should be directed in applying paragraphs 52d and 53, the auditor should assess who might reasonably be expected to have information that is important to the identification and assessment of fraud risks, e.g., individuals who might have additional knowledge about fraud, alleged or suspected fraud or be able to corroborate risks of fraud identified in discussions with management or the audit committee.

55. When evaluating management's responses to inquiries about fraud risks, the auditor should take into account that management is often in the best position to commit fraud in determining when it is necessary to corroborate management's responses. Also, the auditor should obtain evidence to address inconsistencies in responses to the inquiries.

Identifying and Assessing the Risks of Material Misstatement

56. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. In identifying and assessing risks of material misstatement, the auditor should –

    a. Identify the risks of material misstatement due to errors or fraud using information obtained from the risk assessment procedures and considering the characteristics of the accounts and disclosures in the financial statements.[23/]

    b. Evaluate whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions.

    c. Evaluate the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected.

       Note: In identifying and assessing risks of material misstatement at the assertion level, the auditor should evaluate whether the risks of material misstatement at the financial statement level could result in risks of misstatement at the assertion level.

    d. Assess the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the

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[23/] See paragraphs 58-62 for a discussion of factors related to the identification of fraud risks.

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possibility that the risk could result in material misstatement of the financial statements.

Note: In assessing the likelihood and magnitude of potential misstatement, the auditor may take into account the planned degree of reliance on controls selected to test.[24/]

e. Identify significant accounts and disclosures and their relevant assertions.

Note: The determination of whether an account or disclosure is significant or whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls. Refer to paragraphs 28-33 of Auditing Standard No. 5 for additional discussion of identifying significant accounts and disclosures and their relevant assertions.

f. Determine whether any of the identified risks are significant risks.

Note: The determination of whether a risk of misstatement is a significant risk is based on inherent risk, without regard to the effect of controls. (See paragraph 63 for a discussion of factors relevant to identifying significant risks.)

57. For the audit of internal control over financial reporting, paragraph 34 of Auditing Standard No. 5 sets forth certain objectives that the auditor should achieve to further understand the likely sources of potential misstatements and as part of selecting the controls to test. The auditor should take into account the evidence obtained from the procedures performed to achieve the objectives in paragraph 34 of Auditing Standard No. 5 when identifying risks of material misstatement and designing further audit procedures in the audit of financial statements.

Factors Relevant to Identifying Fraud Risks

58. The auditor should evaluate whether the information gathered from the risk assessment procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks. Fraud risk factors are events or conditions that indicate (1) an incentive or pressure to perpetrate fraud, (2) an opportunity to carry out the fraud, or (3) an attitude or

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[24/] See paragraphs 18-19 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement.*

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rationalization that justifies the fraudulent action. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances in which fraud exists.

59. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are listed in paragraph 85 of AU sec. 316 *Consideration of Fraud in a Financial Statement Audit*. These illustrative risk factors are classified based on the three conditions discussed in the preceding paragraph, which generally are present when fraud exists.

   Note: The list of fraud risk factors in AU sec. 316.85 covers a broad range of situations and are only examples. Accordingly, the auditor might identify additional or different fraud risk factors.

60. The auditor should not assume that all of the conditions discussed in the preceding paragraph must be observed or evident to conclude that a fraud risk exists. The auditor might conclude that a fraud risk exists even when only one of the three conditions is present.

61. *Presumption of Fraud Risk Involving Improper Revenue Recognition.* The auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate the types of revenue or revenue transactions to which the risk relates.

62. *Consideration of the Risk of Management Override of Controls.* The auditor's identification of fraud risks should include the risk of management override of controls.

Factors Relevant to Identifying Significant Risks

63. Factors that should be evaluated in determining which risks are significant risks include:

    a. Whether the risk is a fraud risk;

       Note: A fraud risk is a significant risk.

    b. Whether the risk is related to recent significant economic, accounting, or other developments;

    c. The complexity of transactions;

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d. Whether the risk involves significant transactions with related parties;

e. The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

f. Whether the risk involves significant transactions that are outside the normal course of business for the company, or that otherwise appear to be unusual due to their size or nature.

Further Consideration of Controls

64. The auditor should evaluate the design of the company's controls that are intended to address fraud risks and other significant risks and determine whether those controls have been implemented, if the auditor has not already done so when obtaining an understanding of internal control over financial reporting, as described in paragraphs 20-36 of this standard.

> Note: Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, provides direction on the auditor's response to fraud risks and other significant risks.

65. Controls that address fraud risks include (a) specific controls designed to mitigate specific risks of fraud, e.g., controls to address risks of misappropriation of specific assets and (b) controls designed to prevent, deter, and detect fraud, e.g., controls to promote a culture of honesty and ethical behavior.[25/] Such controls also include those that address the risk of management override of other controls.

Revision of Risk Assessment

When the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.

[25/] See AU sec. 316.88 and paragraph 14 of Auditing Standard No. 5.

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APPENDIX A – Consideration of Manual and Automated Systems and Controls

A1. While obtaining an understanding of the company's information system related to financial reporting, the auditor should obtain an understanding of how the company uses IT and how IT affects the financial statements. The auditor also should obtain an understanding of the extent of manual controls and automated controls used by the company. That information should be taken into account in assessing the risks of material misstatement.

> Note: Paragraphs 13-15 of Proposed Auditing Standard, *Audit Planning and Supervision,* establish requirements and provides direction regarding (1) the determination as to whether specialized IT knowledge or skills are needed on an audit and (2) the use of an individual with specialized IT knowledge and skills employed or engaged by the auditor's firm.

A2. Controls in a manual system might include procedures such as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items.

A3. Alternatively, a company might use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format would replace paper documents. When IT is used to initiate, record, process, and report transactions, the IT systems and programs may include controls related to the relevant assertions of significant accounts and disclosures or may be critical to the effective functioning of manual controls that depend on IT.

A4. The auditor should obtain an understanding of specific risks to a company's internal control over financial reporting resulting from IT. Examples of such risks include:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both
- Unauthorized access to data that might result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions or inaccurate recording of transactions. Particular risks might arise when multiple users access a common database
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down segregation-of-duties

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- Unauthorized changes to data in master files
- Unauthorized changes to systems or programs
- Failure to make necessary changes to systems or programs
- Inappropriate manual intervention
- Potential loss of data or inability to access data as required

A5. In obtaining an understanding of the company's control activities, the auditor should obtain an understanding of how the company has responded to risks arising from IT.

A6. When a company uses manual elements in internal control systems, the auditor should design procedures to test the consistency in the application of manual controls.

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APPENDIX 4 – PROPOSED AUDITING STANDARD

October 21, 2008
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

The Auditor's Responses to the Risks of Material Misstatement

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The Auditor's Responses to the Risks of Material Misstatement

Introduction

1. This standard establishes requirements and provides direction regarding designing and implementing appropriate responses to the risks of material misstatement.

2. In particular, this standard discusses the following types of audit responses:

   a. Responses that have an overall effect on how the audit is conducted ("overall responses"), as described in paragraphs 4-5.

   b. Responses involving the nature, timing, and extent of the audit procedures to be performed, as described in paragraphs 6-50.

Objective of the Auditor

3. The objective of the auditor is to address the risks of material misstatement through appropriate overall audit responses and audit procedures.

Overall Responses

4. The auditor should design and implement overall responses to address the risks of material misstatement as follows:

   a. *Making appropriate assignments of significant engagement responsibilities.* The knowledge, skill, and ability of engagement team members with significant engagement responsibilities should be commensurate with the risks of material misstatement.

   b. *Providing an appropriate level of supervision,* as described in paragraphs 18-21 of Proposed Auditing Standard, *Audit Planning and Supervision*.

   c. *Incorporating elements of unpredictability in the selection of audit procedures to be performed.* As part of the auditor's response to the risks of material misstatement due to fraud ("fraud risks"), the auditor should incorporate an element of unpredictability in the selection of auditing procedures to be performed from year to year. Examples of ways to

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incorporate an element of unpredictability are (a) performing audit procedures related to accounts, disclosures and assertions that would not otherwise be tested based on their amount or the auditor's assessment of risk; (b) varying the timing or location of the audit procedures; (c) selecting items for testing that have lower amounts or are otherwise outside customary selection parameters; and (d) performing audit procedures on an unannounced basis.

d. *Evaluating the company's selection and application of significant accounting principles.* The auditor should evaluate whether the company's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions[1/] are indicative of bias that could lead to material misstatement of the financial statements.

Note: Paragraph .11 of AU sec. 380, *Communication With Audit Committees,* discusses auditor judgments about the quality of a company's accounting principles.

e. *Making general changes to the nature, timing, or extent of audit procedures*. The auditor should evaluate whether it is necessary to make general changes to the nature, timing, or extent of audit procedures to adequately address the risks of material misstatement.

5. The auditor's responses to the risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence.[2/] Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence. Examples of the application of professional skepticism in response to fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining additional corroboration of management's explanations or representations concerning important matters, such as through third-party

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1/ Paragraphs 18-19 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* discuss the auditor's responsibilities regarding obtaining an understanding of the company's selection and application of accounting principles.

2/ Paragraph .13 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*

confirmation, use of a specialist engaged or employed by the auditor, or examination of documentation from independent sources.

Responses Involving the Nature, Timing, and Extent of Audit Procedures

6. The auditor should design and perform audit procedures the nature, timing, and extent of which are based on and address the risks of material misstatement for each relevant assertion of each significant account and disclosure.

7. In designing the audit procedures to be performed, the auditor should:

   a. Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

   b. Take into account the types of potential misstatements that could result from the identified risks and the likelihood and magnitude of potential misstatement.

   c. In an integrated audit, design the testing of controls to accomplish the objectives of both audits simultaneously –

      (1) To obtain sufficient evidence to support the auditor's control risk[3/] assessments for purposes of the audit of the financial statements;[4/] and

      (2) To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year end.

8. The audit procedures performed in response to the risks of material misstatement can be classified into two categories – tests of controls and

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[3/] See paragraph 7b of Proposed Auditing Standard, *Audit Risk in an Audit of Financial Statements,* for a definition of control risk.

[4/] For purposes of this standard, the term "audit of the financial statements" refers to the financial statement portion of the integrated audit and to the audit of the financial statements only.

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substantive procedures.[5/] Paragraphs 14-39 of this standard discuss tests of controls, and paragraphs 40-50 discuss substantive procedures.

Responses to Fraud Risks

9. As part of the responses involving the nature, timing, and extent of audit procedures discussed in paragraphs 6-8 of this standard, the auditor should design and perform audit procedures the nature, timing, and extent of which address the fraud risks. The audit procedures that are necessary to address fraud risks depend upon the types of risks and the relevant assertions that might be affected.

    Note: During the audit of internal control or the audit of the financial statements, if the auditor identifies deficiencies in controls that are intended to address fraud risks, the auditor should take into account those deficiencies when developing his or her response to fraud risks.

10. *Addressing Fraud Risks in the Audit of Internal Control.* When planning and performing the audit of internal control over financial reporting ("audit of internal control"), the auditor should take into account the results of his or her fraud risk assessment. As part of identifying and testing entity-level controls and selecting other controls to test, the auditor should evaluate whether the company's controls sufficiently address identified fraud risks and controls intended to address the risk of management override of other controls.[6/]

11. *Addressing Fraud Risks in the Audit of Financial Statements.* In the audit of the financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the fraud risks. The auditor also may perform tests of controls intended to address fraud risks that are selected for testing in accordance with paragraphs 18-19 of this standard.

12. The following are examples of ways in which planned audit procedures may be modified to address fraud risks:

5/ Substantive procedures consist of (a) tests of details of accounts and disclosures and (b) substantive analytical procedures.

6/ Paragraph 14 of Auditing Standard No. 5 and paragraph 65 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement.*

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a. Changing the *nature* of audit procedures to obtain evidence that is more reliable or to obtain additional corroborative information.

b. Changing the *timing* of audit procedures to be closer to the end of the period or to the points during the period in which fraudulent transactions are more likely to occur.

c. Changing the *extent* of the procedures applied to obtain more evidence, e.g., by increasing sample sizes or applying computer-assisted audit techniques to all of the items in an account.

Note: AU secs. 316.53-.66, provide further examples of and additional direction on responses to identified fraud risks relating to fraudulent financial reporting (e.g., revenue recognition, inventory quantities, and management estimates) and misappropriation of assets in the audit of the financial statements.

13. The auditor should perform audit procedures to specifically address the risk of management override of controls including:

a. Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud (AU secs. 316.58-.62),

b. Reviewing accounting estimates for biases that could result in material misstatement due to fraud (AU secs. 316.63-.65), and

c. Evaluating the business rationale for significant unusual transactions (AU secs. 316.66-.67).

Testing Controls

Testing Controls in an Audit of Internal Control[7/]

14. *Objective of Tests of Controls.* The objective of the tests of controls in an audit of internal control under Auditing Standard No. 5 is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the

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[7/] See Auditing Standard No. 5 for further discussion of the auditor's responsibilities for testing controls in the audit of internal control.

effectiveness of the company's internal control over financial reporting as of a point in time and taken as a whole.[8/]

15. *Controls to Be Tested.* To express an opinion on internal control over financial reporting taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.[9/]

> Note*:* In the audit of internal control, the auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting. The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.[10/] Entity-level controls vary in nature and precision.[11/]

> Note: Refer to paragraphs 39-41 of Auditing Standard No. 5 for additional discussion of selection of controls to test in an audit of internal control.

16. *Evidence about the Effectiveness of Controls in the Audit of Internal Control.* For each control selected for testing in the audit of internal control, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.[12/]

[8/] Paragraph B1 of Auditing Standard No. 5.

[9/] Paragraph B2 of Auditing Standard No. 5.

[10/] Paragraph 22 of Auditing Standard No. 5.

[11/] Paragraph 23 of Auditing Standard No. 5. See paragraphs 23 -27 of Auditing Standard No. 5 for further direction regarding the evaluation of entity-level controls.

[12/] Paragraph 46 of Auditing Standard No. 5.

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> Note: Paragraphs 46-48 of Auditing Standard No. 5 provide additional direction regarding the risk associated with a control.

Testing Controls in an Audit of Financial Statements

17. *Objective of Tests of Controls.* The objective of the tests of controls in an audit of financial statements is to obtain sufficient evidence to support the auditor's control risk assessments.

18. *Controls to be Tested.* If the auditor assesses the risk of material misstatement below the maximum level because of reliance on controls,[13/] and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance.[14/]

19. Also, tests of controls should be performed in the audit of financial statements for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence and when necessary to support the auditor's reliance on the completeness and accuracy of financial information used in substantive analytical procedures.[15/]

20. *Evidence about the Effectiveness of Controls in the Audit of Financial Statements.* In designing and performing tests of controls for the audit of the financial

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[13/] As discussed in Proposed Auditing Standard, *Audit Risk in the Audit of Financial Statements,* the risk of material misstatement is a function of inherent risk and control risk. Reliance on controls, when appropriate, allows the auditor to assess control risk below the maximum, which results in a lower assessed risk of material misstatement. In turn, this might allow the auditor to modify the nature, timing, and extent of planned substantive procedures.

[14/] The term "period of reliance" refers to the period being covered by the company's financial statements, or the portion of that period, for which the auditor plans to rely on controls in order to modify the nature, timing, and extent of planned substantive procedures.

[15/] Paragraph .16 of AU sec. 329, *Substantive Analytical Procedures,* states, "Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information."

RELEASE

statements, the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The auditor should obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. The auditor should obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, as, e.g., in situations in which it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

Testing Design Effectiveness

21. The auditor should test the design effectiveness of the controls selected for testing by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

22. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.[16/]

Testing Operating Effectiveness

23. The auditor should test the operating effectiveness of a control selected for testing by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

24. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.[17/]

[16/] Paragraphs 37-38 of Auditing Standard No. 5 provide direction on performing a walkthrough.

[17/] Refer to the Note to paragraph 49 of Auditing Standard No. 5 for discussion of using walkthroughs to obtain evidence of operating effectiveness in the audit of internal control over financial reporting.

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Obtaining Evidence from Test of Controls

25. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing might provide sufficient evidence in relation to the risk associated with the control in an audit of internal control or with the degree of reliance in an audit of financial statements.

    Note: To obtain evidence about whether a control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures.

Nature of Tests of Controls

26. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control.

    Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.

27. The nature of the tests of controls that will provide appropriate evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

    Note: A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain controls, might provide sufficient evidence about whether the control is effective.

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Extent of Tests of Controls

28. The more extensively a control is tested, the greater the evidence obtained from that test.

29. Matters that could affect the necessary extent of testing of a control in relation to the risk associated with a control, or the degree of reliance on a control in a financial statement audit, include the following:

- The frequency of the performance of the control by the company during the audit period
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control
- The expected rate of deviation from a control
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control
- The extent to which audit evidence is obtained from tests of other controls related to the assertion
- The nature of the control, including, in particular, whether it is a manual control or an automated control
- For an automated control, the effectiveness of relevant general controls

  Note: AU sec. 350, *Audit Sampling,* provides direction on the use of sampling in tests of controls.

Timing of Tests of Controls

30. The necessary timing of tests of controls depends on the objective of the test of controls, as discussed in paragraphs 14 and 17 of this standard.

31. In the audit of internal control, the auditor should balance performing the tests of controls closer to the as-of date with the need to test controls over a sufficient period of time to obtain sufficient evidence of operating effectiveness. Testing controls over a greater period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Testing

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performed closer to the date of management's assessment provides more evidence than testing performed earlier in the year.[18/]

32. *Obtaining Evidence about Changes in Controls.* Prior to the period-end date (or the date specified in management's assessment), management might implement changes to the company's controls to make them more effective or efficient or to address deficiencies in internal control over financial reporting.[19/] If the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting.[20/]

33. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment, the auditor should test the design and operating effectiveness of those superseded controls, as appropriate.

34. *Using Audit Evidence Obtained during an Interim Period.* When the auditor obtains evidence about the operating effectiveness of controls at an interim date in an audit of internal control or through an interim date in an audit of financial statements, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.

35. The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors:

- The specific control tested prior to year-end, including the risks associated with the control and the nature of the control, and the results of those tests;
- The sufficiency of the evidence of effectiveness obtained at an interim date;
- The length of the remaining period; and

18/ Paragraph 52 of Auditing Standard No. 5.

19/ See paragraph A3 of Auditing Standard No. 5 for a definition of "deficiency" in internal control over financial reporting.

20/ Paragraph 53 of Auditing Standard No. 5.

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- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

  Note: In some circumstances, such as when evaluation of the foregoing factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.

36. *Using Audit Evidence Obtained in Past Audits.* For audits of internal control, paragraphs 57- 61 of Auditing Standard No. 5 provide direction on incorporating knowledge obtained during past audits and determining the effect of that knowledge on the necessary nature, timing, and extent of testing of controls.

37. For audits of financial statements, the auditor should obtain evidence about the design and operating effectiveness of controls selected for testing in the current year audit. When controls have been tested in past audits, the auditor should take into account the following factors to determine the evidence needed in the current year audit to support the auditor's control risk assessments:

- The inherent risk associated with the related account(s) or assertion(s)
- The nature of the controls and the frequency with which they operate
- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective)
- The planned degree of reliance on the controls
- The nature, timing, and extent of procedures performed in past audits
- The results of the previous years' testing of the control
- Whether there have been changes in the control or the process in which it operates since the previous audit
- For integrated audits, the evidence regarding the effectiveness of the controls obtained during the audit of internal control

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Assessing Control Risk

38. In the audit of the financial statements, the auditor should assess control risk at the assertion level by evaluating the evidence obtained from all sources, including the auditor's testing of controls for the audit of internal control and the audit of the financial statements, misstatements detected during the financial statement audit, and any identified control deficiencies.

39. When deficiencies affecting the controls upon which the auditor intends to rely are detected, the auditor should evaluate the severity of the deficiencies and their potential consequences and should determine whether:

   a. Additional tests of controls (e.g., tests of compensating controls) are necessary; or

   b. The degree of reliance on controls needs to be reassessed and the planned substantive procedures need to be modified as necessary if the assessed risk of material misstatement is increased.

   Note: Auditing Standard No. 5 provides direction on evaluating the severity of a control deficiency and communicating identified control deficiencies to management and the audit committee in an integrated audit. AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements,* provides direction on communicating significant deficiencies and material weaknesses in an audit of financial statements only.

Substantive Procedures

40. The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.

41. In accordance with paragraph 7a of this standard, as the risk of material misstatement increases, the evidence that the auditor should obtain also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures. Further, for an individual assertion, different combinations of the nature, timing, and extent of testing might provide sufficient evidence to respond to the risk of material misstatement.

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Note: In some situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction (a "dual-purpose test"). In those situations, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control.[21/]

Nature of Substantive Procedures

42. Substantive procedures generally provide persuasive evidence when they are designed and performed to obtain evidence that is relevant and reliable. Also, some types of substantive procedures, by their nature, produce more persuasive evidence than others. Inquiry alone does not provide sufficient evidence to support a conclusion about a relevant assertion.

Note: Proposed Auditing Standard, *Audit Evidence,* provides more direction regarding the types of substantive procedures and the relevance and reliability of audit evidence.

43. The auditor should take into account the types of potential misstatements in the relevant assertions that could result from the identified risks when determining the types and combination of substantive audit procedures that are necessary to respond to the risks of material misstatement. Considering the types of potential misstatements can help the auditor design and perform audit procedures to detect those misstatements.

44. *Substantive Procedures Related to the Period-end Financial Reporting Process.* The auditor's substantive procedures must include the following audit procedures related to the period-end financial reporting process:

a. Reconciling the financial statements with the underlying accounting records; and

b. Examining material adjustments made during the course of preparing the financial statements.

[21/] Paragraph .44 of AU sec. 350, *Audit Sampling,* discusses applying audit sampling in dual-purpose tests.

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Note: AU sec. 316.58-.62 provide direction on examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.

45. *Substantive Procedures Responsive to Significant Risks.* For significant risks,[22] the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the risks.

Note: Paragraphs 9-13 of this standard discuss the auditor's responses to fraud risks. Paragraph 63 of Proposed Auditing Standard, *Identifying and Assessing the Risks of Material Misstatement,* discusses identification of significant risks.

Extent of Substantive Procedures

46. The more extensively a substantive procedure is performed, the greater the evidence obtained from the procedure. The extent of a substantive audit procedure that is necessary depends on the materiality of the account or disclosure, the risk of material misstatement, and the degree of assurance the auditor plans to obtain from the procedure. However, increasing the extent of an audit procedure cannot adequately address a risk of material misstatement unless the evidence to be obtained from the procedure is reliable and relevant.

Timing of Substantive Procedures

47. Performing certain substantive procedures at interim dates may permit early consideration of matters affecting the year-end financial statements, e.g., testing material transactions involving higher risks of misstatement. However, performing substantive procedures at an interim date without performing procedures at a later date increases the risk that a material misstatement could exist in the year-end financial statements that would not be detected by the auditor. This risk increases as the period between the interim date and year end increases.

48. In determining whether it is appropriate to perform substantive procedures at an interim date, the auditor should take into account the following:

a. The risk of material misstatement, including:

[22] Paragraph 4a of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement.*

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(1) The auditor's assessment of control risk

(2) The existence of conditions or circumstances, if any, that create incentives or pressures on management to misstate the financial statements between the interim test date and the end of the period covered by the financial statements

b. The nature of the substantive procedures

c. The nature of the account or disclosure and relevant assertion

d. The ability of the auditor to perform the necessary audit procedures to cover the remaining period.

49. When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. Such procedures should include (a) comparing relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual and investigating such amounts, and (b) performing audit procedures to test the remaining period.

50. If the auditor misstatements that he or she did not expect when assessing the risks of material misstatement detects, the auditor should evaluate whether the related assessment of risk and the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified. Examples of such modifications include extending or repeating at the period end the procedures performed at the interim date.

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APPENDIX 5 – PROPOSED AUDITING STANDARD

October 21, 2008
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

Evaluating Audit Results

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Evaluating Audit Results

Introduction

1. This standard establishes requirements and provides direction regarding the auditor's evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.

Objective of the Auditor

2. The objective of the auditor is to evaluate the results of the audit to form the opinion to be expressed in the auditor's report.

Definitions

3. For purposes of this standard, the terms listed below are defined as follows:

   a. Error – An unintentional misstatement in the financial statements.

   b. Misstatement –, A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework.[1/] A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

   c. Uncorrected misstatements – Misstatements accumulated during the audit that management has not corrected.

Evaluating the Results of the Audit of Financial Statements

4. In forming an opinion on the financial statements, the auditor should evaluate all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.

[1/] The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

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5. In the audit of the financial statements,[2/] the auditor's evaluation of audit results should include evaluation of the following:

   a. The results of analytical procedures in the overall review of the financial statements ("overall review");

   b. Identified misstatements;

   c. The qualitative aspects of the company's accounting practices;

   d. Conditions identified during the audit that relate to the assessment of the risk of material misstatement due to fraud ("fraud risk");

   e. The presentation of the financial statements, including disclosures; and

   f. The sufficiency and appropriateness of the audit evidence obtained.

Performing Analytical Procedures in the Overall Review

6. In the overall review, the auditor should read the financial statements and disclosures and perform analytical procedures to (a) assess the auditor's conclusions regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement.

7. In particular, the auditor should evaluate whether

   a. The evidence gathered in response to unusual or unexpected transactions, events or amounts previously identified during the audit is sufficient, and

   b. Unusual or unexpected amounts or relationships[3/] indicate risks of material misstatement that were not identified previously.

2/ For purposes of this standard, the term "audit of the financial statements" refers to the financial statement portion of the integrated audit and to the audit of the financial statements only.

3/ Paragraph 44 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement.*

Note: If the auditor discovers a previously unidentified risk of material misstatement or concludes that the evidence gathered is not adequate, he or she should modify his or her audit procedures or perform additional procedures as necessary in accordance with paragraph 36.

8. The nature, timing, and extent of the analytical procedures that should be performed during the overall review depend on the nature of the company and its industry. These procedures should include analytical procedures relating to revenue through the end of the reporting period.[4/]

9. *Evaluating Whether Analytical Procedures Indicate a Previously Unrecognized Fraud Risk.* The auditor should evaluate whether analytical procedures performed as part of the overall review result in the identification of unusual or unexpected relationships that indicate a fraud risk that was not identified previously.

10. Whether an unusual or unexpected relationship is a fraud risk depends on the relevant facts and circumstances, including the nature of the account or relationship among the data used in the analytical procedures. For example, certain unusual or unexpected relationships could indicate a fraud risk if a component of the relationship involves accounts and disclosures that management has incentives or pressures to manipulate, e.g., significant unusual or unexpected relationships involving year-end revenue and income.

11. The auditor should evaluate whether management's responses to the auditor's inquiries about significant unusual or unexpected trends or relationships have been vague, implausible, or inconsistent with other audit evidence and perform procedures as necessary to address the matter.

Accumulating and Evaluating Identified Misstatements

12. *Accumulating Identified Misstatements.* The auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial.

13. The auditor may designate an amount below which misstatements are clearly trivial and do not need to be accumulated. In such cases, the amount should be set so that any misstatements below that amount would not be material to the

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[4/] Paragraph 43 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* provides direction on performing analytical procedures relating to revenue as part of the risk assessment procedures.

financial statements, individually or in combination with other misstatements, considering the possibility of undetected misstatement.

14. The auditor's accumulation of misstatements should include the auditor's best estimate of the total misstatement in the accounts and disclosures that he or she has tested, not just the amount of misstatements specifically identified. To evaluate the effects of identified misstatements and communicate them to management and the audit committee, the auditor may distinguish specifically identified misstatements, projected misstatements from substantive audit sampling,[5/] and misstatements related to accounting estimates that are outside of a reasonable range.[6/]

15. *Considerations as the Audit Progresses.* The auditor should determine whether the overall audit strategy and audit plan need to be revised if:

   a. the nature of accumulated misstatements and the circumstances of their occurrence indicate that other misstatements might exist that, in combination with accumulated misstatements, could be material; or

   b. the aggregate of misstatements accumulated during the audit approaches the materiality level used in planning and performing the audit. [7/]

   Note: When the aggregate of misstatements approaches the materiality level used in planning and performing the audit, there likely will be a greater than an appropriately low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could be material to the financial statements. If the auditor's assessment of this risk is unacceptably high, he or she should perform additional audit procedures or determine that management has adjusted the financial statements so that the risk that financial statements are materially misstated has been reduced to an appropriately low level.

16. The auditor should communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them.

[5/] AU sec. 350, *Audit Sampling.*

[6/] Paragraph 28 of this standard.

[7/] Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit.*

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17. If management has examined an account or a disclosure in response to misstatements detected by the auditor and has made corrections to the account or disclosure, the auditor should evaluate management's work to determine whether the corrections have been appropriately recorded and whether uncorrected misstatements remain.

18. *Evaluation of the Effect of Uncorrected Misstatements.* The auditor should evaluate whether the uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the accounts and disclosures and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.

    Note: If the financial statements contain material misstatements, the auditor should issue a qualified or an adverse opinion on the financial statements.[8/]

19. The auditor should evaluate the effects of uncorrected misstatements detected in prior years on the accounts and disclosures, and the financial statements as a whole.

20. The auditor cannot assume that an instance of error or fraud is an isolated occurrence. Therefore, the auditor should evaluate the effects of the accumulated misstatements on the assessed risks of material misstatement. This evaluation is important in determining whether the risk assessments remain appropriate, as discussed in paragraph 38 of this standard.

21. *Evaluating Misstatements that Might Be Indicative of Fraud.* The auditor should evaluate whether identified misstatements might be indicative of fraud and, in turn, how they affect the auditor's evaluation of materiality and the related audit responses. As indicated in paragraph .05 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, fraud is an intentional act that results in material misstatement of the financial statements.

22. If the auditor believes that a misstatement is or might be intentional and if the effect on the financial statements could be material or cannot be readily determined, the auditor should attempt to obtain additional audit evidence to determine whether fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements and the auditor's report thereon.

8/ AU sec. 508, *Reports on Audited Financial Statements.*

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23. Also, for any misstatements that the auditor believes are or might be intentional, the auditor should assess the implications for the integrity of management or employees and the possible effect on other aspects of the audit. For example, if the misstatement involves higher-level management, it might be indicative of a more pervasive problem, such as an issue with the integrity of management, even if the amount of the misstatement is small. In such circumstances, the auditor should reevaluate the assessment of fraud risk and the effect of that assessment on (a) the nature, timing, and extent of the necessary tests of accounts or disclosures, and (b) the assessment of the effectiveness of controls. The auditor also should evaluate whether the circumstances or conditions indicate possible collusion involving employees, management, or external parties and, if so, the effect of the collusion on the reliability of evidence obtained.

24. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, he or she also must determine his or her responsibilities under AU sec. 316, AU sec. 317, *Illegal Acts by Clients,* and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1.

Evaluating the Qualitative Aspects of the Company's Accounting Practices

25. When evaluating whether the financial statements as a whole are free of material misstatement, the auditor should assess the qualitative aspects of the company's accounting practices, including possible bias in management's judgments about the amounts and disclosures in the financial statements.

26. The following are examples of forms of management's bias that, if present, the auditor should assess in his or her evaluation of the qualitative aspects of the company's accounting practices:

    a. The selective correction of misstatements brought to management's attention during the audit (e.g., correcting misstatements with the effect of increasing reported earnings but not correcting misstatements that have the effect of decreasing reported earnings).

       Note: To assess the potential effect of selective correction of misstatements, the auditor should obtain an understanding of the reasons why management decided not to correct misstatements communicated by the auditor in accordance with paragraph 16.

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b. Bias in the selection and application of accounting principles.[9/]

c. Bias in accounting estimates. [10/]

27. If the auditor identifies potential bias in management's judgments about the amounts and disclosures in the financial statements, he or she should evaluate whether circumstances producing such a bias represent a risk of a material misstatement due to fraud.

28. *Assessing Bias in Accounting Estimates.* If the auditor concludes that the amount of an accounting estimate included in the financial statements is unreasonable or was not determined in accordance with the applicable accounting principles, he or she should treat the difference between that estimate and the closest reasonable estimate as a misstatement.

29. If an accounting estimate is determined in accordance with the applicable accounting principles and the amount of the estimate is reasonable, a difference between an estimated amount best supported by the audit evidence and the recorded amount of the accounting estimate ordinarily would not be considered to be a misstatement.[11/] However, the auditor should evaluate whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the company's management. For example, if each accounting estimate included in the financial statements was individually reasonable but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income, the auditor should re-assess the estimates taken as a whole.

> Note: AU secs. 316.63-.65 provide additional direction regarding the auditor's consideration of bias in accounting estimates.

9/ Paragraph 5d of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

10/ Paragraphs 28 - 29 of this standard.

11/ Paragraph .14 of AU sec. 342, *Auditing Accounting Estimates.*

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Evaluating Conditions Relating to the Assessment of Fraud Risks

30. When evaluating the results of the audit, the auditor should evaluate whether the accumulated results of auditing procedures[12/] and other observations affect the assessment of the fraud risks made earlier in the audit and the need to modify the audit procedures to respond to those risks.

31. As part of this evaluation, the engagement partner should ascertain whether there has been appropriate communication with the other engagement team members throughout the audit regarding information or conditions indicative of fraud risks.[13/]

32. The auditor's assessment of fraud risks should be ongoing throughout the audit. (See Appendix A.)

Evaluating the Presentation of the Financial Statements, Including the Disclosures

33. The auditor must evaluate whether the financial statements, including the related disclosures, are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

> Note: AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles,* and AU sec. 431, *Adequacy of Disclosure in Financial Statements,* provide additional direction on evaluating the presentation of the financial statements and the adequacy of the financial statement disclosures, respectively. Auditing Standard No. 6, *Evaluating Consistency of Financial Statements,* provides direction on evaluating the consistency of the accounting principles used in financial statements.

[12/] Examples of such auditing procedures include procedures in the overall review (paragraphs 9 - 11 of this standard), the evaluation of identified misstatements (paragraphs 21 -24 of this standard), and the evaluation of the qualitative aspects of the company's accounting practices.

[13/] To accomplish this communication, the engagement partner might arrange another discussion among the audit team members about fraud risks. (See paragraphs 45 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement.*)

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Evaluating the Sufficiency and Appropriateness of Audit Evidence

34. Paragraph 3 of Proposed Auditing Standard, *Audit Risk in an Audit of Financial Statements,* states:

> To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care and obtaining sufficient appropriate audit evidence.

35. As part of evaluating audit results, the auditor must conclude on whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements.

36. Factors that are relevant to the conclusion on whether sufficient appropriate audit evidence has been obtained include the following:

a. Significance of uncorrected misstatements and the likelihood of their having a material effect, individually or in combination, on the financial statements, considering the possibility of further undetected misstatement. Paragraphs 15 and 18-20 of this standard.

b. The results of audit procedures performed in the audit of the financial statements, including whether such audit procedures identified specific instances of fraud, as discussed in paragraphs 21-24 and 30-32 of this standard.

c. The auditor's risk assessments. (See paragraph 38 of this standard.)

d. The results of audit procedures performed in the audit of internal control over financial reporting, if the audit is an integrated audit. (See paragraphs 39-40 of this standard.)

e. The relevance and reliability of the audit evidence obtained.[14/]

[14/] Paragraphs 7-9 of Proposed Auditing Standard, *Audit Evidence,* discuss the relevance and reliability of audit evidence.

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37. If the auditor has not obtained sufficient appropriate audit evidence, the auditor should attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should express a qualified opinion or a disclaimer of opinion.[15/]

38. *Evaluating the Appropriateness of Risk Assessments.* As part of the evaluation of whether sufficient appropriate audit evidence has been obtained, the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate and whether the audit procedures need to be modified or additional procedures need to be performed as a result of any changes in the risk assessments. For example, the reevaluation of the auditor's risk assessments could result in the identification of relevant assertions or significant risks that were not identified previously and for which the auditor should perform additional audit procedures.

> Note: Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* provides further direction on revising the auditor's risk assessment.

39. *Effect of Results of the Audit of Internal Control on Risk Assessments.* In an integrated audit, when concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the company's internal control over financial reporting. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

40. If, during the audit of internal control over financial reporting, the auditor identifies a control deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.[16/]

[15/] AU sec. 508, *Reports on Audited Financial Statements.*

[16/] Paragraph 39 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement.*

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Evaluating the Results of the Audit of Internal Control Over Financial Reporting

Forming an Opinion on the Effectiveness of Internal Control Over Financial Reporting

41. In accordance with Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements,* the auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls for the audit of internal control over financial reporting and the financial statement audit, misstatements detected during the financial statement audit, and any identified control deficiencies.

42. Auditing Standard No. 5 describes the auditor's responsibilities regarding evaluating the results of the audit, including evaluating the identified control deficiencies.[17/]

Effect of Financial Statement Audit on the Conclusion About the Effectiveness of Internal Control Over Financial Reporting

43. The auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting.[18/]

44. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on internal control over financial reporting, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements.[19/]

> Note: Also, reevaluation of the auditor's risk assessments, as discussed in paragraph 38, could affect the audit of internal control over financial

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[17/] For example, paragraphs 62-70 of Auditing Standard No. 5 discuss evaluating identified control deficiencies and paragraphs 71-73 of Auditing Standard No. 5 discuss forming an opinion on the effectiveness of internal control over financial reporting.

[18/] Paragraph B8, Auditing Standard No. 5.

[19/] Paragraph B3, Auditing Standard No. 5.

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reporting, e.g., if it results in the identification of relevant assertions that were not identified previously.

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Appendix A – Matters That Might Affect the Assessment of Fraud Risks

A1. If matters such as the following are identified during the audit, the auditor should determine whether the assessment of fraud risks needs to be reassessed:

a. Discrepancies in the accounting records, including:

(1) Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or company policy

(2) Unsupported or unauthorized balances or transactions

(3) Last-minute adjustments that significantly affect financial results

(4) Evidence of employees' access to systems and records that is inconsistent with the access that is necessary to perform their authorized duties

(5) Tips or complaints to the auditor about alleged fraud

b. Conflicting or missing evidence, including:

(1) Missing documents

(2) Documents that appear to have been altered[1/]

(3) Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist

(4) Significant unexplained items on reconciliations

(5) Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures

(6) Unusual discrepancies between the company's records and confirmation replies

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[1/] Paragraph 9 of Proposed Auditing Standard, *Audit Evidence.*

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(7) Missing inventory or physical assets of significant magnitude

(8) Unavailable or missing electronic evidence, that is inconsistent with the company's record retention practices or policies

(9) Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments

(10) Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships – for example, receivables growing faster than revenues

(11) Large numbers of credit entries and other adjustments made to accounts receivable records

(12) Unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statement and the accounts receivable sub-ledger

(13) Missing or non-existent cancelled checks in circumstances in which cancelled checks are ordinarily returned to the company with the bank statement

(14) Fewer responses to confirmation requests than anticipated or a greater number of responses than anticipated

c. Problematic or unusual relationships between the auditor and management, including:

(1) Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought, including:[2/]

[2/] Denial of access to information might constitute a limitation on the scope of the audit that requires the auditor to qualify or disclaim an opinion. (See Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements,* and AU sec. 508, *Reports on Audited Financial Statements.*)

a. Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques

b. Denial of access to key IT operations staff and facilities, including security, operations, and systems development

(2) Undue time pressures imposed by management to resolve complex or contentious issues

(3) Management pressuring engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management

(4) Unusual delays by management in providing requested information

(5) An unwillingness to add or revise disclosures in the financial statements to make them more complete and transparent

(6) An unwillingness to appropriately address significant deficiencies in internal control on a timely basis

d. Other:

(1) Objections by management in permitting the auditor to meet privately with the audit committee

(2) Accounting policies that appear inconsistent with industry practices that are widely recognized and prevalent

(3) Frequent changes in accounting estimates that do not appear to result from changing circumstances

(4) Tolerating violations of the company's code of conduct

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APPENDIX 6 – PROPOSED AUDITING STANDARD

October 21, 2008
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

Consideration of Materiality in Planning and Performing an Audit

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Consideration of Materiality in Planning and Performing an Audit

Introduction

1. This standard establishes requirements and provides direction regarding the auditor's consideration of materiality in planning and performing an audit.

   Note: Proposed Auditing Standard, *Evaluating Audit Results,* establishes requirements and provides direction regarding the auditor's consideration of materiality in evaluating audit results*.*

Materiality in the Context of an Audit

2. Financial reporting frameworks[1/] discuss the concept of materiality in the context of the preparation and presentation of financial statements. For example, Financial Accounting Standards Board Statement of Financial Accounting Concepts ("FASB Concepts Statement") No. 2, *Qualitative Characteristics of Accounting Information,* states "The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item."[2/]

3. To obtain reasonable assurance about whether the financial statements are free of material misstatement, the auditor should design and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements.

[1/] The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

[2/] The formulation in the FASB Concepts Statement is similar to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." (TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).) As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him …." TSC Industries, 426 U.S. at 450.

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Note: When performing audit procedures, the auditor should be alert for misstatements that could be qualitatively material. Also, the auditor should evaluate uncorrected misstatements based on qualitative and quantitative factors. (See paragraph 18 of Proposed Auditing Standard, *Evaluating Audit Results.)* However, it ordinarily is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors.

Objective of the Auditor

4. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing audit procedures.

Considering Materiality When Planning and Performing the Audit

Materiality for the Financial Statements as a Whole

5. When planning the audit, the auditor should establish a materiality level for the financial statements as a whole that is appropriate in light of the surrounding circumstances.[3/] To determine the nature, timing, and extent of audit procedures, the materiality level for the financial statements as a whole needs to be expressed as a specified amount.

Note: If financial statements for the audit period are not available, the auditor may establish an initial materiality level based on estimated or preliminary financial statement amounts. In those situations, the auditor should take into account the effects of known or expected changes in the company's financial statements, e.g., significant transactions or adjustments that are expected to be reflected in the financial statements at the end of the period.

6. Paragraph 20 of Auditing Standard No. 5 states, "In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she uses in the audit of the company's annual financial statements."

Materiality for Particular Accounts or Disclosures

7. The auditor should evaluate whether, in light of the surrounding circumstances, there are particular accounts or disclosures for which there is a substantial

[3/] FASB Concepts Statement No. 2.

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likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. If so, the auditor should establish separate materiality levels for those accounts or disclosures.

Determining Tolerable Misstatement

8. The auditor should determine the amount or amounts of tolerable misstatement[4/] for purposes of assessing risks of material misstatement and planning and performing audit procedures. Tolerable misstatement should be established at an amount or amounts that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the financial statements. Accordingly, the amount or amounts of tolerable misstatement should be less than the materiality level for the financial statements as a whole and, if applicable, the materiality level or levels for particular accounts or disclosures.

9. In determining tolerable misstatement and planning and performing audit procedures, the auditor should take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods.

Considerations as the Audit Progresses

10. The auditor should reassess the established materiality level or levels and tolerable misstatement if (1) the materiality level or levels and tolerable misstatement were established initially based on estimated or preliminary financial statement amounts that differ significantly from actual amounts at the end of the period covered by the financial statements or (2) the financial statements used in establishing the materiality level or levels and in determining tolerable misstatement have changed significantly, e.g., because of significant adjustments to the financial statements.

11. If the auditor's reassessment results in a lower amount for the materiality level or levels or tolerable misstatement than the auditor's initial determination, the auditor should (1) evaluate the effect, if any, of the lower amount or amounts on his or her risk assessments and audit procedures and (2) modify the nature, timing, and extent of audit procedures as necessary to obtain sufficient appropriate audit evidence.

[4/] Paragraph .18 of AU sec. 350, *Audit Sampling*.

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Note: The reassessment of the materiality level or levels and tolerable misstatement is also relevant to the auditor's evaluation of identified misstatements in accordance with paragraph 18 of Proposed Auditing Standard, *Evaluating Audit Results.*

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APPENDIX 7 – PROPOSED AUDITING STANDARD

October 21, 2008
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

Audit Evidence

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Audit Evidence

Introduction

1. This standard establishes requirements and provides direction regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.

2. Audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the audit opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and any information that contradicts such assertions.

Objective of the Auditor

3. The objective of the auditor is to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report.

   Note: Proposed Auditing Standard, *Evaluating Audit Results,* establishes requirements and provides direction regarding evaluating whether sufficient appropriate evidence has been obtained. Auditing Standard No. 3, *Audit Documentation,* establishes requirements and provides direction regarding documenting the procedures performed, evidence obtained, and conclusions reached in an audit.

Sufficient Appropriate Audit Evidence

4. The auditor must plan and perform the audit to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion.

5. Sufficiency is the measure of the *quantity* of audit evidence. The quantity of audit evidence needed is affected by the following:

   - *Risk of material misstatement (in the audit of financial statements) or the risk associated with the control (in the audit of internal control over financial reporting).* As the risk increases, the amount of evidence that the auditor should obtain also increases.

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- *Quality of the audit evidence obtained.* As the quality of the evidence increases, the need for additional corroborating evidence decreases. Obtaining more of the same type of audit evidence, however, cannot compensate for the poor quality of that evidence.

6. Appropriateness is the measure of the quality of audit evidence; i.e., its relevance and reliability. To be appropriate, audit evidence must be both relevant and reliable. Relevance and reliability are discussed in the following paragraphs.

Relevance and Reliability

7. *Relevance.* The relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The relevance of audit evidence depends on:

   a. The design of the audit procedure used to test the assertion or control, in particular whether it is designed to (1) test the assertion or control directly and (2) test for understatement or overstatement; and

   b. The timing of the audit procedure used to test the assertion or control.

8. *Reliability.* The reliability of evidence depends on the nature and source of the evidence and the circumstances under which it is obtained. For example, in general:

   - Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources

   - The reliability of information generated internally by the company is increased when the company's controls over that information are effective

   - Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly

   - Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise converted into electronic form, the reliability of which depends on the controls over the conversion and maintenance of those documents

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9. The auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions.

Using Information Produced by the Company

10. When using information produced by the company, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit, by performing procedures such as:[1/]

- Testing the accuracy and completeness of the information, or testing the controls over the accuracy and completeness of that information

- Evaluating whether the information is sufficiently precise and detailed for purposes of the audit

Use of Assertions in Obtaining Audit Evidence

11. In representing that the financial statements are presented fairly in conformity with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures. Those assertions can be classified into the following categories:

- *Existence or occurrence* – Assets or liabilities of the company exist at a given date and recorded transactions have occurred during a given period.

- *Completeness* – All transactions and accounts that should be presented in the financial statements are so included.

- *Valuation or allocation* – Asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts.

[1/] AU sec. 336, *Using the Work of a Specialist, establishes* requirements and provides direction for regarding using the work of a specialist employed or engaged by the company.

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- *Rights and obligations* – Assets are rights of the company, and liabilities are obligations of the company at a given date.

- *Presentation and disclosure* – The components of the financial statements are properly classified, described, and disclosed.

12. The auditor may base his or her work on assertions that differ from those in this standard if:

    a. In the audit of financial statements, the assertions are sufficient for the auditor to identify the types of potential misstatements and appropriately respond to the risks of material misstatement in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated, and

    b. If the audit is an integrated audit of the financial statements and internal control over financial reporting, the auditor has selected and tested controls over the pertinent risks in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated.[2]

Audit Procedures for Obtaining Audit Evidence

13. The auditor should design and perform audit procedures to obtain sufficient appropriate audit evidence. Such audit procedures can be classified into the following categories:

    a. Risk assessment procedures[3/] and

    b. Further audit procedures,[4/] which consist of:

        (1) Test of controls and

[2/] Paragraph 28 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

[3/] Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement.*

[4/] Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement.*

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(2) Substantive procedures, including tests of details and substantive analytical procedures.

14. Paragraphs 15 – 21 of this standard describe specific audit procedures. The purpose of an audit procedure determines whether it is a risk assessment procedure, test of controls, or substantive procedure.

Inspection

15. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorization.

Observation

16. Observation consists of looking at a process or procedure being performed by others, e.g., the auditor's observation of inventory counting by the company's personnel, or of the performance of control activities. Observation can provide audit evidence about the performance of a process or procedure, but the evidence is limited to the point in time at which the observation takes place, and also is limited by the fact that the act of being observed may affect how the process or procedure is performed.

> Note: AU sec. 331, *Inventories,* establishes requirements and provides direction regarding observation of the counting of inventory.

Inquiry

17. Inquiry consists of seeking information from knowledgeable persons in financial or nonfinancial roles within the company or outside the company. Inquiry may be performed throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

> Note: Inquiry alone does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant

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assertion or to support a conclusion about the effectiveness of a control.

Note: AU sec. 333, *Management Representations,* establishes requirements and provides direction regarding written management representations, including confirmation of management responses to oral inquiries.

External Confirmation

18. An external confirmation represents audit evidence obtained by the auditor as a direct response to the auditor from a third party. Written confirmations might be received in paper form, or by electronic or other medium. External confirmation procedures frequently are used in relation to account balances and their constituent parts, e.g., confirmation of receivables by communication with debtors. However, external confirmations need not be restricted to these items. For example, if the auditor requests confirmation of the terms of a company's agreements or transactions with third parties, the confirmation request may be designed to ask if any modifications have been made to the agreement or if side agreements exist and, if so, what the relevant details are.

Note: AU sec. 330, *The Confirmation Process,* establishes requirements and provides direction regarding confirmations.

Recalculation

19. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Reperformance

20. Reperformance involves the independent execution of procedures or controls that were originally performed by company personnel.

Analytical Procedures

21. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of significant differences from expected amounts.

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Note: AU sec. 329, *Substantive Analytical Procedures,* establishes requirements and provides direction on performing analytical procedures as substantive procedures.

Selecting Items for Testing to Obtain Audit Evidence

22. Designing substantive tests of details and tests of controls includes determining the means of selecting items for testing from among the items included in an account or based on the occurrences of a control. The auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. The alternative means of selecting items for testing are:

- Selecting all items
- Selecting specific items
- Audit sampling

23. The particular means or combination of means of selecting items for testing, that is appropriate depends on the nature of the audit procedure; the characteristics of the control or the items comprising the account being tested; and the evidence necessary to meet the objective of the audit procedure.

Selecting All Items

24. Selecting all items (100 percent examination) refers to testing the entire population of the occurrences of a control or items that comprise an account (or a stratum within that population). The following are examples of situations in which 100 percent examination might be applied:

- The population constitutes a small number of large value items;
- The audit procedure is designed to respond to a significant risk and other means of selecting items for testing do not provide sufficient appropriate audit evidence; or
- The repetitive nature of a calculation or other process performed automatically by an information system makes a 100 percent examination cost effective.

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Selecting Specific Items

25. Selecting specific items refers to testing all of the items in a population that have a specified characteristic, such as:

- *Key items.* The auditor may decide to select specific items within a population because they are important to accomplishing the objective of the audit procedure or exhibit some other characteristic, e.g., items that are suspicious, unusual, particularly risk-prone or that have a history of error.

- *All items over a certain amount.* The auditor may decide to examine items whose recorded values exceed a certain amount to verify a large proportion of the total amount of the items included in an account.

26. The auditor also might select specific items to obtain an understanding about matters such as the nature of the company or the nature of transactions.

27. The application of audit procedures to items that are selected as described in paragraphs 24-25 of this standard does not constitute audit sampling, and the results of those audit procedures cannot be projected to the entire population.

Audit Sampling

28. Audit sampling is the application of an audit procedure to less than 100 percent of the occurrences of a control or items comprising an account for the purpose of evaluating some characteristic of the control or account.

> Note: AU sec. 350, *Audit Sampling,* establishes requirements and provides direction regarding audit sampling.

Inconsistency in, or Doubts about the Reliability of, Audit Evidence

29. If audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should assess the effect if any, on other aspects of the audit.

Public Company Accounting Oversight Board

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APPENDIX 8 – PROPOSED CONFORMING AMENDMENTS TO PCAOB STANDARDS

October 21, 2008

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

PROPOSED CONFORMING AMENDMENTS TO PCAOB STANDARDS

Public Company Accounting Oversight Board

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Proposed Conforming Amendments to PCAOB Standards

Auditing Standards

AU sec. 110, "Responsibilities and Functions of the Independent Auditor"

Statement on Auditing Standard ("SAS") No. 1, "Codification of Auditing Standards and Procedures" section 110, "Responsibilities and Functions of the Independent Auditor" (AU sec. 110, "Responsibilities and Functions of the Independent Auditor"), is amended as follows –

> Within footnote 1 to paragraph .02, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit.*

AU sec. 150, "Generally Accepted Auditing Standards"

SAS No. 95, "Generally Accepted Auditing Standards" (AU sec. 150, "Generally Accepted Auditing Standards"), as amended, is amended as follows –

a. Within paragraph .02, in the third standard of field work, the word "competent" is replaced with "appropriate."

b. Footnote 2 to paragraph .04 is deleted.

AU sec. 230, "Due Professional Care in the Performance of Work"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 230, "Due Professional Care in the Performance of Work" (AU sec. 230, "Due Professional Care in the Performance of Work"), as amended, is amended as follows –

a. Within footnote 3 to paragraph .06, the reference to AU sec. 311, *Planning and Supervision,* paragraph .07 is deleted.

b. Within footnote 4 to paragraph .06, the phrase "See section 311.11" is replaced with, "See paragraph 19 of Proposed Auditing Standard, *Audit Planning and Supervision*."

c. Footnote 6 to paragraph 11 is deleted.

d. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

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e. At the end of the fifth sentence of paragraph .12, the following parenthetical is added: "(See paragraph 8 of Proposed Auditing Standard, *Audit Evidence*.)"

AU sec. 310, "Appointment of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 310, "Appointment of the Independent Auditor" (AU sec. 310, "Appointment of the Independent Auditor"), as amended, is amended as follows –

a. Within footnote ** to the title of the standard, the reference to AU section 313, *Substantive Tests Prior to the Balance Sheet Date,* is deleted.

b. In paragraph .02:

- The word "assistant" is replaced with "engagement team members."
- The first reference to AU section 311, *Planning and Supervision,* is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision.*
- The second reference to AU section 311 is replaced with a reference to Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement.*

c. In paragraphs .02 and .03, the references to AU section 313, *Substantive Tests Prior to the Balance Sheet Date,* are deleted.

d. Within footnote 3 to paragraph .06, the reference to paragraph .04 of section 312, *Audit Risk and Materiality in Conducting an Audit,* is replaced with a reference to paragraph 3 of Proposed Auditing Standard, *Evaluating Audit Results.*

AU sec. 311, "Planning and Supervision"

SAS No. 22, "Planning and Supervision" (AU 311, "Planning and Supervision"), as amended, is superseded.

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AU sec. 9311, "Planning and Supervision: Auditing Interpretations of Section 311"

AU sec. 9311, "Planning and Supervision: Auditing Interpretation of Section 311" is superseded.

AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"

SAS No. 47, "Audit Risk and Materiality in Conducting an Audit" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), as amended, is superseded.

AU sec. 9312, "Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312"

AU sec. 9312, "Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312" is superseded.

AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"

SAS No. 45, "Omnibus Statement on Auditing Standards – 1983" (AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"), as amended, is superseded.

AU sec. 315, "Communications Between Predecessor and Successor Auditors"

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows –

a. In the first sentence of paragraph .12, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .18, the word "competent" is replaced with the word "appropriate."

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows –

a. The second sentence of paragraph .01 is replaced with –

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This section establishes requirements and provides direction relevant to fulfilling that responsibility, as it relates to fraud, in an audit of financial statements. [fn 2]

b. In footnote 1 to paragraph .01, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is deleted.

c. Footnote 2 to paragraph .01 is replaced with –

For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of the financial statements only.

d. Paragraph .01A is added –

.01A Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* establishes requirements and provides direction regarding identifying and assessing the risks of material misstatement, including risks of material misstatement due to fraud ("fraud risks"). Proposed Auditing Standard, *The Auditor's Responses* to *the Risks of Material Misstatement,* establishes requirements and provides direction regarding the auditor's overall responses and the audit procedures performed to respond to the risks of material misstatement, including fraud risks. Proposed Auditing Standard, *Evaluating Audit Results,* establishes requirements and provides direction regarding the evaluation of the results of the audit, including evaluating at the completion of the audit whether the accumulated results of auditing procedures and other observations affect the fraud risk assessment and whether identified misstatements may be indicative of fraud.

e. In paragraph .02:

- The third through the sixth bullet points are deleted.
- The seventh bullet point is replaced with –

  Responding to fraud risks. This section discusses certain responses to fraud risks involving the nature, timing, and extent of audit procedures, including:

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- o Responses to fraud risks relating to fraudulent financial reporting and misappropriation of assets (see paragraph .53 through .56).
- o Responses to specifically address the fraud risks arising from management override of internal controls (see paragraphs .57 through .67).

- The eighth bullet point is deleted.
- In the second sentence of the ninth bullet point , "guidance" is replaced with "direction."

f. Paragraph .03 is deleted.

g. Footnote 6 to paragraph .08 is deleted.

h. Paragraphs .14 through .45 are deleted, along with the preceding heading, "Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud".

i. Footnotes 8 through 19, related to paragraphs .14 through .45 are deleted.

j. Paragraphs .46 through .50 are deleted. The heading preceding paragraph .46 is replaced with the heading, "Responding to Fraud Risks."

k. Paragraph .51 is deleted. The heading preceding paragraph .51 is replaced with the heading, "Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed."

l. Paragraph .52 is replaced with –

Paragraph 9 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement,* states that "the auditor should design and perform audit procedures the nature, timing, and extent of which address the fraud risks. The audit procedures that are necessary to address fraud risks depend upon the types of risks and the relevant assertions that might be affected."

m. In paragraph .53:

- The first sentence is replaced with –

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The following are examples of responses to fraud risks involving the nature, timing, and extent of audit procedures:

- The fifth bullet point is replaced with –

  Interviewing personnel involved in activities in areas where a fraud risk has been identified to obtain their insights about the risk and how controls address the risk (See paragraph 53 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*).

- The sixth bullet point is replaced with –

  If other independent auditors are auditing the financial statements of one or more subsidiaries, divisions, or branches, discussing with them the extent of work that needs to be performed to address fraud risks resulting from transactions and activities among these components.

n. Footnote 20 to paragraph .53 is replaced with –

AU sec. 329, *Substantive Analytical Procedures*, establishes requirements and provides direction regarding performing analytical procedures as substantive tests.

o. The heading preceding paragraph .54, "Additional Examples of Responses to Identified Risks of Misstatements Arising From Fraudulent Financial Reporting" is replaced with "Additional Examples of Audit Procedures Performed to Respond to Fraud Risks Relating to Fraudulent Financial Reporting."

p. The first sentence in paragraph .54 is replaced with –

The following are additional examples of audit procedures that might be performed in response to fraud risks relating to fraudulent financial reporting:

q. Footnotes 21 and 22 to paragraph .54 are amended as follows –

- The text of footnote 21 is replaced with "AU sec. 330, *The Confirmation Process*, establishes requirements and provides

RELEASE

direction regarding the confirmation process in audits of financial statements."

- The text of footnote 22 is replaced with "AU sec. 336, *Using the Work of a Specialist*, establishes requirements and provides direction to an auditor who uses the work of a specialist in performing an audit of financial statements."

r. The heading preceding paragraph .55, "Examples of Responses to Identified Risks of Misstatements Arising From Misappropriations of Assets" is replaced with the heading, "Examples of Audit Procedures Performed to Respond to Fraud Risks Relating to Misappropriations of Assets."

s. In paragraph .56:

- The first and second sentences are replaced with –

  The audit procedures performed in response to a fraud risk relating to misappropriation of assets usually will be directed toward certain account balances. Although some of the audit procedures noted in paragraphs .53 and .54 and in paragraphs 9 through 13 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement,* may apply in such circumstances, such as the procedures directed at inventory quantities, the scope of the work should be linked to the specific information about the misappropriation risk that has been identified.

- In the third sentence, the words "design and" are added before the words "operating effectiveness."

t. The heading preceding paragraph .57, "Responses to Further Address the Risk of Management Override of Controls," is replaced with the heading "Audit Procedures Performed to Specifically Address the Risk of Management Override of Controls."

u. The third sentence of paragraph .57 is replaced with –

Accordingly, as part of auditor's responses that address fraud risks, the procedures described in paragraphs .58 through .67 should be performed to specifically address the risk of management override of controls.

RELEASE

v. Footnote 23 to paragraph .58 is replaced with –

See paragraphs 29 through 33 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

w. In paragraph .61:

- In the second bullet point, the last two sentences are replaced with the following –

  Effective controls over the preparation and posting of journal entries and adjustments may affect the extent of substantive testing necessary, provided that the auditor has tested the controls. However, even though controls might be implemented and operating effectively, the auditor's substantive procedures for testing journal entries and other adjustments should include the identification and testing of specific items.

- In the last sentence of the fifth bullet point, the reference to section 312.18, is replaced with paragraph 11 of Proposed Auditing Standard, *Audit Planning and Supervision*.

x. In the third sentence of paragraph .63, the reference to section 312.36 is replaced with a reference to paragraphs 25 through 29 of Proposed Auditing Standard, *Evaluating Audit Results*.

y. Paragraphs .68 through .78 are deleted, along with the preceding heading "Evaluating Audit Evidence."

z. Footnotes 26 through 36, related to paragraphs .68 through .78 are deleted.

aa. The last sentence of paragraph .80 is replaced with –

The auditor also should evaluate whether the absence of or deficiencies in controls that address fraud risks or otherwise help prevent, deter, and detect fraud (see paragraph 22 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*) represent significant deficiencies that should be communicated to senior management and the audit committee.

bb. The first sentence of paragraph .81 is replaced with –

Public Company Accounting Oversight Board

RELEASE

The auditor should consider communicating other fraud risks, if any, identified by the auditor.

cc. In paragraph .83:

- The reference in the first bullet point to paragraphs .14 through .17 is replaced with paragraphs 45 through 49 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

- The reference in the second bullet point to paragraphs .19 through .34 is replaced with paragraphs 37 through 44, paragraphs 50 through 55, and paragraphs 64 through 65 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

- The third bullet point is replaced with –

  The fraud risks that were identified at the financial statement and assertion levels (see paragraphs 56 through 65 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*), and the linkage of those risks to the auditor's response (see paragraphs 4 through 13 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.)

- The reference in the fourth bullet point to paragraph .41 is replaced with paragraph 61 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

- The fifth bullet point is replaced with –

  The results of the procedures performed to address the assessed fraud risks, including those to further address the risk of management override of controls (see paragraph 13 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatements.*)

- The reference in sixth bullet point to paragraphs .68 through .73 is replaced with a reference to paragraphs 6 through 11 of Proposed Auditing Standard, *Evaluating Audit Results*.

PCAOB
Public Company Accounting Oversight Board

RELEASE

dd. Paragraph .84 and the accompanying heading, "Effective Date," are deleted.

ee. The first sentence of paragraph .85 is replaced with –

This appendix contains examples of risk factors discussed in paragraphs 58 through 60 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

AU sec. 317, "Illegal Acts by Clients"

SAS No. 54, "Illegal Acts by Client" (AU section 317, "Illegal Acts by Clients"), is amended as follows –

a. The last sentence of paragraph .13 is replaced with –

An illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

b. In paragraph .19, the word "competent" is replaced with the word "appropriate."

AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"

SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), as amended, is superseded.

AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"

SAS No. 65, "The Auditor's Consideration of Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), as amended, is amended as follows –

a. In the first sentence of paragraph .02, the word "competent" is replaced with the word "appropriate."

b. Within footnote 3 to paragraph .04, the reference to AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit,* is

RELEASE

replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

c. In the first sentence of paragraph .18, the word "competent" is replaced with the word "appropriate."

d. Within footnote 5 to paragraph .18, the reference to AU 326, *Evidential Matter*, paragraph .19c. is replaced with a reference to Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, paragraph 44.

e. Within footnote 8 to paragraph 27, the reference to AU sec. 311, *Planning and Supervision*, paragraphs .11 through .13 is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*, paragraphs 18 through 21.

<u>AU sec. 324, "Service Organizations"</u>

SAS No. 70, "Service Organizations" (AU 324, "Service Organization), as amended, is amended as follows –

a. In the first sentence of paragraph .07, the reference to section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

b. In the first sentence of paragraph .16, the reference to section 319.90 through .99, is replaced with a reference to Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, paragraphs 34 through 35.

c. In the second sentence of paragraph .23, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit,* is replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*.

<u>AU sec. 326, "Evidential Matter"</u>

SAS No. 31, "Evidential Matter" (AU sec. 326, "Evidential Matter"), as amended, is superseded.

PCAOB
Public Company Accounting Oversight Board

RELEASE

AU sec. 9326, "Evidential Matter: Auditing Interpretations of Section 326"

AU sec. 9326, "Evidential Matter: Auditing Interpretations of Section 326," as amended, is amended –

a. In the fourth sentence of paragraph .01, the word "competent" is replaced with "appropriate."

b. In the first sentence of paragraph .03, the word "competent" is replaced with "appropriate."

c. The third and fourth sentences of paragraph .03 are replaced with –

   In selecting particular substantive tests to achieve the audit objectives he has developed, an auditor considers, among other things, the risk of material misstatement of the financial statements, including the assessed level of control risk, and the expected effectiveness and efficiency of such tests. His considerations include the nature and materiality of the items being tested, the kinds and competence of available evidential matter, and the nature of the audit objective to be achieved.

d. The second sentence in paragraph .04 is replaced with –

   Audit testing at interim dates may permit early consideration of significant matters affecting the year-end financial statements (e.g., related party transactions, changed conditions, recent accounting pronouncements, and financial statement items likely to require adjustment) and that much of the audit planning, including obtaining an understanding of internal control over financial reporting and assessing control risk, and the application of substantive tests to transactions can be conducted prior to the balance-sheet date. (See Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement.*)

e. Footnote 1 to paragraph .04 is deleted.

f. The reference in paragraph .10 to section 326, *Evidential Matter*, paragraph .25, is replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*, paragraph 37.

g. In the first and second sentences of paragraph .10, the word "competent" is replaced with "appropriate."

RELEASE

h. The last two sentences of paragraph .12 are deleted.

i. In the second sentence of paragraph .12, the word "competent" is replaced with "appropriate."

j. In the first sentence of paragraph .13, the word "competent" is replaced with "appropriate."

k. In paragraph .17, the word "competent" is replaced with "appropriate."

l. In the second sentence of paragraph .21, the word "competent" is replaced with "appropriate."

m. In the fourth sentence of paragraph .22, the word "competent" is replaced with "appropriate."

n. In paragraph .23, the word "competent" is replaced with "appropriate."

o. The reference in paragraph .24 to section 326, *Evidential Matter*, paragraph .03, is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*, paragraph 11.

p. In the fourth sentence of paragraph .33, the word "competent" is replaced with "appropriate."

<u>AU sec. 328, "Auditing Fair Value Measurements and Disclosures"</u>

SAS No. 101, "Auditing Fair Value Measurements and Disclosures" (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), as amended, is amended as follows –

a. In the first sentence of paragraph .03, the word "competent" is replaced with "appropriate."

b. The reference in paragraph .11 to Section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

c. The reference in paragraph .14, to section 319 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial*

PCAOB
Public Company Accounting Oversight Board

RELEASE

Statements, paragraph A5, second note. The reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, is deleted.

d. Within paragraph .25, in the second sentence in the second bullet point and the first sentence in the third bullet point, the word "competent" is replaced with "appropriate."

e. In the second sentence of paragraph .32, the word "competent" is replaced with "appropriate."

f. In the first sentence of paragraph .42, the word "competent" is replaced with "appropriate."

g. In the second sentence of paragraph .44, the word "competent" is replaced with "appropriate."

h. The reference in paragraph .47 to section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraphs .36 through 41, is replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*, paragraphs 14 through 19 and 25 through 29.

AU sec. 329, "Analytical Procedures"

SAS No. 56, "Analytical Procedures" (AU sec. 329, "Analytical Procedures"), as amended, is amended as follows –

a. The title of the standard "Analytical Procedures" is replaced with "Substantive Analytical Procedures."

b. The text of paragraph .01 is replaced with –

This section establishes requirements and provides direction on the use of substantive analytical procedures in an audit.

Note: Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* establishes requirements and provides direction regarding performing analytical procedures as a risk assessment procedure in identifying and assessing the risks of material misstatement.

PCAOB
Public Company Accounting Oversight Board

RELEASE

> Note: Proposed Auditing Standard, *Evaluating Audit Results,* establishes requirements and provides direction on performing analytical procedures as part of the overall review stage of the audit.

c. Paragraph .03 is deleted.

d. The text of paragraph .04 is replaced with –

Analytical procedures are used as a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions. Analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

e. Paragraphs .06 - .08 and the accompanying heading are deleted.

f. At the end of paragraph .09, a new sentence is added –

(See paragraph 19 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement.*)

g. Within footnote 1 to paragraph 9, the reference to section 326, *Evidential Matter* is replaced with a reference to Proposed Auditing Standard, *Audit Evidence.*

h. Footnote 2 to paragraph .20 is deleted.

i. In the second sentence of paragraph .21, the word "likely" is deleted.

j. Footnote 3 to paragraph .21 is deleted.

k. Paragraphs .23 and .24 and the accompanying headings are deleted.

AU sec. 330, "The Confirmation Process"

SAS No. 67, "The Confirmation Process" (AU sec. 330, "The Confirmation Process"), is amended as follows –

a. The references in paragraph .02 to section 312, *Audit Risk and Materiality in Conducting an Audit*, and section 313, *Substantive Tests Prior to the Balance Sheet Date*, are replaced with a reference to Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

RELEASE

b. The reference in paragraph .05 to section 312 is replaced with a reference to Proposed Auditing Standard, *Audit Risk in an Audit of Financial Statements*.

c. The second sentence of paragraph .06 is replaced with –

See proposed Auditing Standard, *Audit Evidence*, paragraph 8, which discusses reliability of audit evidence.

d. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate." The reference in the third sentence to Section 326 is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*.

e. In the first sentence of paragraph .24, the word "competence" is replaced with the word "appropriateness."

f. In the last sentence of paragraph .27, the word "competent" is replaced with the word "appropriate."

<u>AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"</u>

SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investment in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), as amended, is amended as follows –

a. The reference in paragraph .01 to section 326, *Evidential Matter*, paragraphs .03 – .08, is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*, paragraphs 11 and 12.

b. The reference in paragraph .06, to Section 311, *Planning and Supervision,* is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*.

c. The first and second sentences of paragraph .07 are deleted. The third sentence is replaced with –

The auditor should design and perform audit procedures regarding relevant assertions of derivatives and investments in securities that are based on and that address the risks of material misstatement in those assertions.

PCAOB
Public Company Accounting Oversight Board

RELEASE

d. The reference in paragraph .09 to Section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

e. The reference in paragraph .11 to Section 319.47 is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* paragraphs .20 through .32.

f. The reference to section 319 in paragraph .15 is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

g. The last sentence of paragraph .35, is replaced with –

In addition, Proposed Auditing Standard, *Evaluating Auditing Results*, paragraphs 25 through 29, provide directions on assessing bias in accounting estimates.

h. In paragraph .43, subpart a., the word "competent" is replaced with the word "appropriate."

i. In paragraph .57, subpart c., the word "competent" is replaced with the word "appropriate."

<u>AU sec. 333, "Management Representations"</u>

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows –

a. Footnote 4 to paragraph .06, is replaced with –

Proposed Auditing Standard, *Evaluating Audit Results*, indicates that a misstatement can arise from error or fraud and discusses the auditor's responsibilities for evaluating accumulated misstatements.

b. Within footnote 6 to paragraph .06, the reference to Section 312, is replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*, paragraph 13.

RELEASE

c. Within footnote 7 to paragraph .06, the reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, paragraphs .38 through .40, is replaced with a reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, paragraphs .79 through .82.

AU sec. 334, "Related Parties"

SAS No. 45 "Related Parties" (AU sec. 334 "Related Parties"), is amended as follows –

a. In the second sentence of paragraph .09, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .11 the word "competent" is replaced with "appropriate".

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334"

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334," is amended as follows –

Within footnote 4 to paragraph .17, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Proposed Auditing Standard, *Audit Risk in an Audit of Financial Statements*.

AU sec. 336, "Using the Work of a Specialist"

SAS No. 73, "Using the Work of a Specialist" (AU sec. 336 "Using the Work of a Specialist"), is amended as follows –

a. The reference in paragraph .05 to section 311, *Planning and Supervision*, is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*.

b. In the last sentence of paragraph 6, the word "competent" is replaced with the word "appropriate."

c. In the first and last sentences of paragraph .13, the word "competent" is replaced with the word "appropriate."

RELEASE

AU sec. 9336 "Using the Work of a Specialist: Auditing Interpretations of Section 336"

AU sec. 9336, "Using the Work of a Specialist: Auditing Interpretations of Section 336," is amended as follows –

a. In the second sentence of paragraph .04, the word "competent" is replaced with the word "appropriate."

b. In paragraph .05, the word "competent" is replaced with the word "appropriate."

c. In the second sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

d. The penultimate sentence of paragraph .15, is replaced with –

Proposed Auditing Standard, *Audit Evidence*, paragraph 6, states "to be appropriate, audit evidence must be both relevant and reliable."

AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"

SAS No. 59, "The Auditor's Consideration of an Entity's Ability to Continue as Going Concern" (AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"), as amended, is amended as follows –

The reference in paragraph .02, to section 326, *Evidential Matter*, is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*.

AU sec. 342, "Auditing Accounting Estimates"

SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), as amended, is amended as follows –

a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .07, the word "competent" is replaced with the word "appropriate."

PCAOB
Public Company Accounting Oversight Board

RELEASE

c. The reference in paragraph .08b.1. to section 311, *Planning and Supervision*, is replaced with Proposed Auditing Standard, *Audit Planning and Supervision*.

d. Paragraph .14, is replaced with –

Proposed Auditing Standard, *Evaluating Audit Results*, paragraphs 25 through 29, discuss the auditor's responsibilities for assessing bias and evaluating accounting estimates in relationship to the financial statements taken as whole.

AU sec. 9342, "Auditing Accounting Estimates: Auditing Interpretations of Section 342"

AU sec. 9342, "Auditing Accounting Estimates: Auditing Interpretations of Section 342," is amended as follows –

In the second sentence of paragraph .02, the word "competent" is replaced with the word "appropriate."

AU sec. 350, "Audit Sampling"

SAS No. 39, "Audit Sampling" (AU sec. 350, "Audit Sampling"), as amended, is amended as follows –

a. Within footnote 2 to paragraph .02, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*.

b. The last sentence of paragraph .03 is replaced with –

Either approach to audit sampling can provide sufficient evidential matter when applied properly. This section applies to both nonstatistical and statistical sampling.

c. Paragraph .04 is deleted.

d. Within paragraph .06, the first sentence is deleted; in the last sentence, the word "competence" is replaced with the word "appropriateness," and the following Note is added to the paragraph:

RELEASE

Note: Proposed Auditing Standard, *Audit Evidence*, discusses the appropriateness of audit evidence, and Proposed Auditing Standard, *Evaluating Audit Results,* discusses the auditor's responsibilities for evaluating the sufficiency and appropriateness of audit evidence.

e. In paragraph .07, the first sentence is replaced with –

Some degree of uncertainty is implicit in the concept of "a reasonable basis for an opinion," as described in paragraph 4 of Proposed Auditing Standard, *Audit Evidence*.

f. Paragraph .08 is deleted.

g. The reference in paragraph .09 to section 313 is deleted; the following note is added to paragraph .09 –

Note: Paragraphs 5 through 10 of Proposed Auditing Standard, *Audit Risk in an Audit of Financial Statements,* describes audit risk and its components in a financial statement audit – the risk of material misstatement (consisting of inherent risk and control risk) and detection risk.

h. The reference in paragraph .11 to section 311, *Planning and Supervision*, is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*.

i. The second sentence of paragraph .15, is replaced with –

For general direction regarding planning, refer to Proposed Auditing Standard, *Audit Planning and Supervision*.

j. The reference in the first bullet in paragraph .16 to section 326, *Evidential Matter*, is deleted. In the second bullet, the phrase "preliminary judgment about materiality" is replaced with the phrase "Tolerable misstatement. (See paragraph .18.)"

k. Paragraph .18 is replaced with –

Evaluation in monetary terms of the results of a sample for a substantive test of details contributes directly to the auditor's purpose, since such an evaluation can be related to his or her judgment of the monetary amount of misstatements that would be material. When planning a sample for a

PCAOB
Public Company Accounting Oversight Board

RELEASE

substantive test of details, the auditor should consider how much monetary misstatement in the related account balance or class of transactions may exist, in combination with other misstatements, without causing the financial statements to be materially misstated. This maximum monetary misstatement for the balance or class is called *tolerable misstatement*.

Note: See paragraphs 8 through 9 of Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit,* for direction regarding determining tolerable misstatement.

Note: When the population to be sampled constitutes a portion of an account balance or transaction class, the auditor should determine tolerable misstatement for the population to be sampled for purposes of designing the sampling plan. Tolerable misstatement for the population to be sampled may be less than tolerable misstatement for the account balance or transaction class to allow for the possibility of misstatement in the portion of the account or class not subject to audit sampling.

l. Paragraph .20 is deleted.

m. The first sentence of paragraph .21, is replaced with the following sentence –

The sufficiency of tests of details for a particular account balance or class of transactions is related to the individual importance of the items examined as well as to the potential for material misstatement.

n. Paragraph .23 is replaced with –

To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account tolerable misstatement; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements.

o. Paragraph .23A is added –

Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical

RELEASE

sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used.. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

p. The last sentence of paragraph .25 is replaced with –

The auditor also should evaluate whether the reasons for his or her inability to examine the items have implications in relation to his or her risk assessments, particularly the assessment of the risk of material misstatement due to fraud, the implications on the integrity of management or employees, and the possible effect on other aspects of the audit.

q. Footnote 6 to paragraph .26 is replaced with –

Paragraphs 12 through 24 of Proposed Auditing Standard, *Evaluating Audit Results,* discuss the auditor's consideration of differences between the accounting records and the underlying facts and circumstances.

r. Within footnote 7 to paragraph .32, the reference to section 319.85 is deleted. In the first sentence of the footnote the phrase "often plans" is replaced with the phrase "may plan." The last sentence of the footnote, which is in brackets, is deleted.

s. The following sentences are added to the end of paragraph .38 –

When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

t. The fifth sentence of paragraph .39 is replaced with –

Paragraphs 47 through 49, of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, provides direction on performing procedures between the interim date of testing and period end.

RELEASE

u. In paragraph .39, the last sentence, which is in brackets, is deleted.

v. In paragraph .44:

- The first sentence is replaced with –

  In some circumstances the auditor may design a sample that will be used for dual purposes: as a test of control and a substantive test.

- The third sentence is replaced with –

  For example, an auditor designing a test of a control over entries in the voucher register may design a related substantive test at a risk level that is based on an expectation of reliance on the control to assess control risk below the maximum.

- The fifth sentence is replaced with –

  In evaluating such tests, deviations from the control that was tested and monetary misstatements should be evaluated separately using the risk levels applicable for the respective purposes.

- The following Note is added to the paragraph –

  Note: The note to paragraph 41 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, provides additional direction regarding performing dual-purpose tests.

w. The reference in paragraph .45 to paragraph .04 is changed to paragraph .03.

x. In item 2 of paragraph .48, the last sentence is deleted.

y. The reference in item 6 of paragraph .48, to section 313 is deleted.

z. Within footnote 1 to item 4 in paragraph .48, the sentence in the brackets is deleted, and the sentence referring to section 313, which is in parentheses, is deleted.

PCAOB
Public Company Accounting Oversight Board

RELEASE

AU sec. 9350, "Audit Sampling: Auditing Interpretations of Section 350"

AU sec. 9350, "Audit Sampling: Auditing Interpretations of Section 350" is superseded.

AU sec. 380, "Communication With Audit Committees"

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees") as amended, is amended as follows –

The reference in footnote 5 to paragraph .10 to section 316A.38 -.40 is replaced with a reference to AU sec. 316.79 - .82.

AU sec. 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles"

SAS No. 69, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles" (AU sec. 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles") is amended as follows –

The reference in footnote 1 to paragraph .04 to 312.10, is replaced with Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements" (AU sec. 508 "Reports on Audited Financial Statements"), as amended, is amended as follows –

a. In paragraph .20a., the word "competent" is replaced with the word "appropriate."

b. In the second sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."

c. In the third sentence of paragraph .24, the word "competent" is replaced with the word "appropriate."

d. The references in paragraph .49, to section 312, *Audit Risk and Materiality in Conducting an Audit*, and to section 342, *Auditing Accounting Estimates*, are replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*, paragraphs 25 through 29.

PCAOB
Public Company Accounting Oversight Board

RELEASE

e. In the first sentence of paragraph .63, the word "competent" is replaced with the word "appropriate."

AU sec. 9508, "Reports on Audited Financial Statements: Auditing Interpretations of Section 508"

AU sec. 9508, "Reports on Auditing Financial Statements: Auditing Interpretations of Section 508", is amended as follows –

In paragraph .02, the word "competent" is replaced with the word "appropriate."

AU sec. 530, "Dating of the Independent Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 530, "Dating of the Independent Auditor's Report" (AU 530, "Dating of the Independent Auditor's Report"), as amended, is amended as follows –

a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."

b. In the second note to paragraph .01, the word "competent" is replaced with the word "appropriate."

c. In the first sentence of paragraph .05, the word "competent" is replaced with the word "appropriate."

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretation of Section 543"

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretation of Section 543", is amended as follows –

Footnote 4 to paragraph .16 is deleted.

AU sec. 623, "Special Reports"

SAS No. 62, "Special Reports" (AU sec. 623, "Special Reports"), as amended, is amended as follows –

PCAOB
Public Company Accounting Oversight Board

RELEASE

The reference in paragraph .24 to AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows –

a. Within footnote 7 to paragraph .11 the first sentence is replaced with –

Proposed Auditing Standard, *Evaluating Audit Results*, paragraphs 12 through 24, require the auditor to accumulate and evaluate the misstatements identified during the audit.

b. The reference in paragraph .13 to section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

c. The last sentence of paragraph .16, is replaced with –

The accountant may find the direction in section 329, *Substantive Analytical Procedures*, useful in conducting a review of interim financial information.

d. Footnote 20, to paragraph .26 is deleted.

e. The reference in paragraph .56 to section 319 is replaced with a reference to section 316.

AU sec. 901, "Public Warehouse-Controls and Auditing Procedures for Goods Held"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 901, "Public Warehouses-Controls and Auditing Procedures for Goods Held" (AU sec. 901, "Public Warehouse-Controls and Auditing Procedures for Goods Held"), as amended, is amended as follows –

Within footnote 3 to paragraph .04, the reference to section 326 is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*.

RELEASE

Auditing Standard No. 3, *Audit Documentation*

Auditing Standard No. 3, *Audit Documentation*, as amended, is amended as follows –

The first sentence of paragraph A37, is replaced with –

> Paragraph 29 of Proposed Auditing Standard, *Audit Evidence*, states: "If audit evidence obtained from one source is inconsistent with that obtained from another, or the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter, and should assess the effect if any, on other aspects of the audit."

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, as amended, is amended as follows –

a. Within the note to paragraph 10, the reference to AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

b. In the first sentence of paragraph 18, the word "competent" is replaced with "appropriate."

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, is amended as follows –

a. In the second sentence of paragraph 3, the word "competent" is replaced with the word "appropriate."

b. Within footnote 10 to paragraph 14, the reference to paragraphs .19 through .42 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

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c. The reference in paragraph 15 to AU sec. 316.44 and .45 is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*. paragraphs 64 through 65.

d. Within footnote 11 to paragraph 20, the reference to AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*.

e. Within footnote 12 to paragraph 28, the reference to AU sec. 326, *Evidential Matter*, is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*.

f. Within footnote 13 to the note to paragraph 31, the reference to AU sec. 312.39 is replaced with a reference to Proposed Auditing Standard, *Evaluating Auditing Results*, paragraphs 13 through 15. The reference to AU sec. 316.50 is replaced with a reference to Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, paragraph 4.

g. The references in paragraph 36 to paragraphs .16 through .20, .30 through .32, and .77 through .79 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, are replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* Appendix A.

h. In the first sentence of paragraph 51, the word "competent" is replaced with "appropriate."

i. In the first sentence of paragraph 89, the word "competent" is replaced with "appropriate."

j. Within the note to paragraph C6, the word "competent" is replaced with "appropriate."

Ethics Standards

ET sec. 102, "Integrity and Objectivity"

ET sec. 102, "Integrity and Objectivity," is amended as follows –

RELEASE

Within footnote 1 to paragraph .05, the reference to SAS No. 22, *Planning and Supervision* [AU Section 311] is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*.

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APPENDIX 9

Additional Discussion of Proposed Auditing Standards and Conforming Amendments

Proposed Auditing Standard – Audit Risk in an Audit of Financial Statements

1. Background

This proposed standard would establish requirements and provide direction regarding the auditor's consideration of audit risk in an audit of financial statements.

The proposed standard indicates that, to form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. It also states that reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care and obtaining sufficient appropriate audit evidence.[1/]

The proposed standard describes audit risk in a financial statement audit. It also discusses the relationships among the various types of risk comprising audit risk. The Board believes that these audit risk concepts are fundamental to the auditing standards and should be retained in PCAOB auditing standards. The descriptions of the types of audit risk and their relationships are similar to the respective discussions in AU sec. 312, *Audit Risk and Materiality in Conducting an Audit* of the existing PCAOB standards.

Question

1. Does the proposed standard appropriately describe audit risk and its component risks?

[1/] See AU sec. 110, *Responsibilities and Functions of the Independent Auditor,* and AU sec. 230, *Due Professional Care in the Performance of Work,* for a further discussion of reasonable assurance.

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Proposed Auditing Standard – Audit Planning and Supervision

1. Background

This proposed standard describes the auditor's responsibilities for planning an audit and supervising the work of engagement team members. It would supersede AU sec. 311, *Audit Planning and Supervision.*

The concept of audit planning has evolved since the Auditing Standards Board of the AICPA ("ASB") developed AU sec. 311, which contemplates that auditors will obtain an understanding of the company and its industry to plan the audit. With the increased use of risk-based audit methodologies, some auditors have devoted more attention to obtaining an understanding of the company and its environment, and the procedures performed to obtain this understanding are part of their risk assessment procedures. Many of the procedures that were formerly considered part of audit planning are now discussed in the proposed standard on identifying and assessing risks of material misstatement, as in the risk assessment standards of the International Audit and Assurance Standards Board ("IAASB"). The proposed standard on audit planning and supervision provides additional direction on planning matters such as developing an appropriate audit strategy and audit plan. In addition, it indicates that the engagement partner is responsible for planning the audit and supervising engagement team members. The proposed standard also indicates that the engagement partner may seek assistance from other engagement team members because, in many situations, particularly those involving larger or multi-location engagements, it is appropriate and necessary to do so.

2. Audit Planning

The proposed standard sets forth a principle for determining the necessary nature, timing, and extent of planning activities based on, e.g., the size and complexity of the company. The proposed standard then provides requirements and direction for the important aspects of planning, including performing preliminary engagement activities.

The audit strategy, also known as the audit approach, sets the scope, timing and direction of the audit. Although AU sec. 311 mentions audit strategy in the context of audit planning, the proposed standard provides more direction regarding the development of the audit strategy. The audit plan, which is referred to as an audit program in AU sec. 311, describes the planned audit procedures to be performed. The proposed standard retains the requirement in AU sec. 311.05 for a written audit plan.

Paragraph 7 of the proposed standard indicates that, as part of establishing the audit strategy and audit plan, the auditor should determine whether certain matters specified in the standard are important to the company's financial statements and

RELEASE

internal control over financial reporting and, if so, how they will affect the auditor's procedures. This responsibility is an extension of a requirement in paragraph 9 of Auditing Standard No. 5.

Giving consideration to the matters listed in paragraph 7 of the proposed standard, some of which are in AU sec. 311, can lead auditors to develop more effective audit strategies and audit plans. For example, consideration of those matters can highlight areas that might warrant additional attention during the auditor's risk assessment procedures, which, in turn, could affect the audit procedures performed in response to the risks of material misstatement. Also, consideration of the internal control related matters can help the auditor develop an appropriate audit strategy, e.g., in determining accounts for which reliance on controls might be appropriate in the audit of the financial statements.

Paragraph 11 of the proposed standard sets forth requirements and direction regarding multi-location engagements, which have been retained from AU sec. 312.18. The requirements and direction, however, have been refined to align more closely with corresponding requirements and direction in Auditing Standard No. 5 for the audit of internal control over financial reporting. In particular, the proposed standard clarifies that the risk of material misstatement is a factor to consider in determining the locations for which testing needs to be performed.

The proposed standard also provides new direction regarding pre-engagement activities and initial audits that is similar to requirements in International Standard on Auditing ("ISA") 300, *Planning an Audit of Financial Statements*.

Individuals with Specialized Skill or Knowledge

The proposed standard includes requirements and direction regarding persons with specialized skill or knowledge. Generally, the requirements and direction have been retained from AU secs. 311.10 and 319.31-.32 of the interim standards.

The proposed standard indicates that the auditor should evaluate whether specialized skill or knowledge is needed to perform appropriate risk assessments, apply the planned audit procedures, or evaluate the results of the audit. This responsibility has been extended from a similar requirement in AU 311.10 regarding considering whether specialized information technology ("IT") skill or knowledge is needed on an audit. The Board believes that extending the requirement to individuals with specialized skill or knowledge in areas other than IT, such as forensic specialists, valuation specialists, and actuarial specialists is important because of the prevalent use of such individuals by auditors.

3. Supervision

In the supervision section of the proposed standard, the Board generally retained the requirements and direction regarding supervision from AU sec. 311, making changes as needed to conform to the terminology and requirements of the other proposed risk assessment standards.

Questions

2. Is it reasonable and appropriate to extend the Auditing Standard No. 5 requirement regarding consideration of matters important to the audit of internal control over financial reporting to audits of financial statements?

3. Is the direction regarding multi-location engagements reasonable and appropriate?

4. Is more direction needed regarding multi-location engagements? If so, in what areas is additional direction needed?

5. Are the responsibilities of the engagement partner for planning and supervision appropriate and reasonable, and is the proposed direction clear?

Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement

1. Background

This proposed standard describes the auditor's responsibilities for the process of identifying and assessing risks of material misstatement. This process includes (1) information-gathering procedures, known as "risk assessment procedures," and (2) evaluation of the information obtained in order to identify the risks of material misstatement and assess the significance of those risks.

In a risk-based audit, the auditor's testing of controls and testing of accounts and disclosures are directed toward the areas of greatest risk. The effectiveness of a risk-based audit, therefore, depends to a significant degree on whether the auditor identifies the risks of material misstatement and has an appropriate basis for assessing those risks. An effective risk assessment process is important in both the audit of internal control over financial reporting and the audit of financial statements.

Information from the Board's oversight activities has also indicated deficiencies in risk identification and assessment that led to inadequate or inappropriate audit

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RELEASE

procedures. [2] Inappropriate identification or assessment of risks of material misstatements can lead to overlooking relevant risks to the financial statements, e.g., business conditions that affect asset quality or create pressures to manipulate the financial statements, or assessing risks too low without having an appropriate basis for the assessment. In turn, these situations can lead to misdirected or inadequate audit work. Enhancing the direction in the auditing standards for identifying and assessing risks should lead auditors to improve their risk assessments and their ability to focus on areas of increased risk.

Under the proposed standard, the auditor's risk assessment procedures should be adequate to allow him or her to identify those risks that have a reasonable possibility of resulting in material misstatement of the financial statements and related disclosures and to have a reasonable basis for assessing the potential for material misstatement resulting from those risks.

2. Risk Assessment Procedures

The overarching principle related to risk assessment procedures is set forth in paragraph 5, which indicates that the auditor should perform risk assessment procedures to obtain sufficient appropriate evidence to identify and appropriately assess the risks of material misstatement due to error or fraud and to design further audit procedures.

The standard then sets forth requirements for performing risk assessment procedures, including obtaining an understanding of the company, its environment, and its internal control over financial reporting.

Obtaining an Understanding of the Company and Its Environment

AU sec. 311 of the interim standards describes the auditor's responsibilities for obtaining an understanding of the company and its environment. The proposed

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[2] For example, PCAOB Release No. 2007-004, "Report on the Second-Year Implementation of Auditing Standard No. 2, *An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements*" (April 18, 2007), cited instances in which auditors assessed the level of risk only at the account level, which can lead to inadequate testing of higher risk assertions and excessive testing of lower risk assertions. Also, PCAOB Release No. 2007-010, "Report on the PCAOB'S 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms" (October 22, 2007), cited instances in which auditors failed to identify risk factors relating to potential impairments of assets and doubts about entities' ability to continue as a going concern.

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Public Company Accounting Oversight Board

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standard would expand the required understanding of the company and its environment to include certain additional matters, which are discussed in the following paragraphs.

Paragraph 13 sets forth additional procedures that the auditor should consider performing as part of obtaining an understanding of the company and its environment:

- Reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting
- Observing or reading transcripts of earnings calls
- Obtaining information about significant unusual developments regarding trading activity in the company's securities
- Obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements; changes or adjustments to those arrangements and special bonuses

Members of the Board's Standing Advisory Group suggested that these matters could provide valuable information for identifying risks of material misstatement in many audits of issuers, e.g., to obtain information about business risks relevant to financial reporting or to identify incentives or pressures on management to manipulate financial results. Also, the PAE Report recommended that auditors consider published analysts' reports and forecasts while gaining an understanding of the company's business and industry, assessing risks, and evaluating identified misstatements.[3/] The Board believes that these procedures can provide important information on many audits, so the proposed standard establishes a responsibility to consider performing these procedures in each audit.

The proposed standard imposes a responsibility to evaluate how significant changes in the company from prior periods, including changes in its internal control, affect the risks of material misstatement. Existing PCAOB standards recognize that financial reporting risks can arise due to circumstances such as changes in operating environment; new personnel; new or revamped information systems; rapid growth; new technology; new business models, products, or activities; corporate restructurings; expanded foreign operations; and new accounting pronouncements.[4/] The proposed

[3/] Public Oversight Board, Panel on Audit Effectiveness, Report and Recommendations ("PAE Report") (August 31, 2000), p. 58.

[4/] AU sec. 319.38.

RELEASE

standard requires the auditor to specifically evaluate the effect of such changes on the risks to the financial statements.

The proposed standard also would require the auditor to obtain an understanding of the company's objectives, strategies and related business risks in order to identify those business risks that could result in material misstatement of the financial statements, which the ISAs also require. The PAE Report recommended that auditors be required to obtain an understanding of the company's business risks.[5/] The proposed standard provides examples of business risks that may result in a risk of material misstatement of the financial statements. However, the list of examples is meant to be illustrative rather than a checklist of factors to consider. Auditors would need to consider the business risks that are relevant to the particular company and industry. For example, in today's economic environment, business risks might include financing risks (e.g., access to necessary financing) or product risks (e.g., investments in certain financial products).

Also like the IAASB standards, the proposed standard would require the auditor to obtain an understanding of the company's performance measures that affect the risks of material misstatement. Understanding performance measures can help the auditor to identify accounts or disclosures that might be susceptible to manipulation to achieve targets for certain performance measures or to understand how management uses performance measures to monitor risks affecting the financial statements.

PCAOB standards require auditors to obtain an understanding of the accounting practices common to the industry and to evaluate the quality of a company's accounting principles as part of his or her response to fraud risks and in determining matters to be communicated to the audit committee.[6/] The proposed standard, like the ISA, imposes a responsibility to obtain an understanding of the applicable financial reporting framework and to evaluate whether the company's selection and application of accounting principles is consistent with the applicable accounting framework and the accounting principles used in the relevant industry. Such procedures can provide important information for identifying relevant matters such as (1) accounts that are susceptible to misstatement, e.g., if an account balance is determined using accounting principles that are inconsistent with the applicable financial reporting framework, or (2) more general conditions that affect risks of material misstatement, e.g., if the company's accounting principles are more aggressive than those used in the relevant industry.

5/ PAE Report, p. 58.

6/ AU secs. 316 and 380.

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Public Company Accounting Oversight Board

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The proposed standards use the term used in the ISAs, "applicable financial reporting framework," rather than "generally accepted accounting principles." The Board believes the term used in the ISAs is appropriate for the audits of issuers. The proposed standard contains a footnote indicating that the auditor should look to the requirements of the U.S. Securities and Exchange Commission ("SEC") for the company under audit to determine the accounting principles applicable to that company. This formulation should focus the auditor on the accounting principles that may be used for purposes of the federal securities laws. This formulation is also consistent with an amendment to AU sec. 411 that was adopted by the Board when it adopted Auditing Standard No. 6.[7/]

Obtaining an Understanding of Internal Control Over Financial Reporting

The proposed standard describes the auditor's responsibilities regarding obtaining an understanding of internal control over financial reporting. Although the auditor's primary focus is on internal control over financial reporting ("understanding of internal control"), the proposed standard also indicates that the auditor may obtain an understanding of controls related to operations or compliance objectives if they pertain to data the auditor plans to use in applying auditing procedures. These requirements are, in substance, equivalent to those in AU sec. 319, but the formulation in the proposed standard is aligned more clearly with Auditing Standard No. 5.

Like the interim standard, the proposed standard sets forth certain principles regarding the sufficiency of the auditor's understanding of internal control over financial reporting. Under the proposed standard, the auditor has a responsibility to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures. The proposed standard also indicates that the nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control over financial reporting depend on the size and complexity of the company; the auditor's strategy regarding testing controls; the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's internal controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting. For example, the auditor's procedures to obtain an understanding of internal control would be more extensive when the auditor's strategy involves more testing of controls (e.g., in an integrated audit), the company's internal control is more complex, or the company's controls have changed significantly.

[7/] PCAOB Release No. 2008-001, Auditing Standard No. 6, *Evaluating Consistency of Financial Statements and Conforming Amendments* (January 29, 2008).

RELEASE

Also like the interim standard, the proposed standard indicates that the understanding of internal control includes consideration of whether the controls are appropriately designed and implemented. In accordance with the principles discussed in the preceding paragraph, the amount of audit attention devoted to design and operating effectiveness will vary based on the auditor's strategy for testing controls. For example, if the auditor plans to test controls, more attention should be devoted to controls that the auditor plans to test because he or she will need to evaluate both the design and operating effectiveness of those controls.

To describe the auditor's responsibilities for obtaining an understanding of internal control, it was necessary to describe internal control over financial reporting in terms of its components. The components set forth in the proposed standard are similar to those used in the Board's interim standard, AU sec. 319, and in the respective standards of the IAASB. However, auditors may use other suitable recognized frameworks[8/] in accordance with the direction in the standard. If the auditor uses a suitable, recognized internal control framework with components that differ from those listed in the preceding paragraph, the auditor should adapt the requirements in the proposed standard to conform to the components in the framework used.

The interim standard requires the auditor to consider the collective effect on the control environment of strengths and weaknesses in the various control environment factors.[9/] The proposed standard replaces that requirement with a new requirement to assess the following matters as part of obtaining an understanding of the control environment:

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

This new requirement in the proposed standard is aligned more clearly with the requirements in Auditing Standard No. 5 for evaluating the control environment. However, the Board does not expect that the auditor's process for assessing the control

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8/ See Securities Exchange Act Release No. 34-47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

9/ AU sec. 319.35-.36.

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environment in an audit of financial statements only to be the same as that required when expressing an opinion on internal control over financial reporting. For audits of financial statements only, the proposed standard allows the auditor to base his or her assessment on evidence obtained as part of obtaining an understanding of the control environment and other relevant knowledge possessed by the auditor.

The proposed standard would expand the auditor's responsibility for obtaining an understanding of the information system relevant to financial reporting. Under the proposed standard, like the ISAs, the auditor would be expected to obtain an understanding about relevant business processes relating to financial reporting. This was also a recommendation in the PAE Report.[10/] The proposed standard provides additional direction to auditors in determining relevant business processes.

Also, the proposed standard expands the direction regarding understanding the period-end financial reporting process[11/] by describing important elements of that process. Because that process is a common source of potential misstatements, the Board believes that it is important for the auditor to have an adequate understanding of the aspects of the period-end financial reporting process in all audits, including audits of financial statements only. However, the proposed standard requires the auditor only to obtain an understanding of the process, whereas Auditing Standard No. 5 requires the auditor also to evaluate that process in the audit of internal control over financial reporting.

Considering Information from the Client Acceptance and Retention Evaluation and from Other Engagements

Paragraph .15b of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice,* indicates that a firm's quality control policies and procedures regarding client acceptance and retention should provide reasonable assurance that the firm "appropriately considers the risks associated with providing professional services in the particular circumstances." The matters that auditors consider when deciding whether to accept or retain a client or engagement may include information that is relevant to identifying risks of material misstatement, e.g., fraud risk factors or matters affecting the company's financial condition or operations. Similarly, the auditor might obtain information during audit planning that affects the risks of material misstatement. The proposed standard imposes a responsibility on auditors to

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[10/] PAE Report, p 15.

[11/] AU sec. 319.49. The existing standard uses the term "financial reporting process used to prepare the entity's financial statements" but the proposed standard uses the same term as Auditing Standard No. 5.

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Public Company Accounting Oversight Board

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take into account relevant information obtained from the engagement acceptance or retention evaluation and audit planning activities in identifying the risks of material misstatement. Also, the proposed standard specifically states that risks of material misstatement identified during those activities should be included in the auditor's assessment of risks so the auditor can implement appropriate responses to those risks.

Another potential source of information about risks of misstatement is other engagements performed for the company. For example, if the auditor has performed a review of interim financial information in accordance with AU sec. 722, *Interim Financial Information,* the proposed standard states that the auditor should evaluate whether information obtained during the review is relevant to identifying risks of material misstatement in the year-end audit. The proposed standard also indicates that the auditor should assess whether information obtained in other engagements performed for the company is likely to be important for identifying risks of material misstatement. It also provides direction on how this requirement might be met in multi-location engagements.

Performing Analytical Procedures as Risk Assessment Procedures

The proposed standard retains the requirements and direction from AU sec. 329 regarding performing analytical procedures during the planning phase of the audit. Such analytical procedures are, in essence, risk assessment procedures, so the respective requirements and direction have been incorporated into the proposed standard.

Conducting a Discussion among Engagement Team Members Regarding Risks of Material Misstatement

AU sec. 316 requires a discussion among engagement team members about risks of material misstatement due to fraud. The proposed standard, like the ISAs, extends this requirement to cover risks of material misstatement due to errors or fraud.

A discussion among engagement team members about the risks of material misstatement is intended to:

- Provide an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the company

- Allow the engagement team members to exchange information about the business risks affecting the company and about how those risks could result in material misstatement due to fraud or error

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- Help engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures

- Provide a basis upon which engagement team members can communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks[12/]

Through its inspections program, the Board has observed deficiencies relating to discussion among engagement team members regarding fraud risks.[13/] including instances in which key engagement team members did not participate. Since the engagement team discussion would be expanded to cover all risks of material misstatement, the Board evaluated whether the direction in AU sec. 316 could be enhanced to improve performance in this area. The Board decided to modify the formulation regarding the participation in the engagement team discussion to state more directly that the key engagement members should participate in the discussion and to explain that key engagement team members include the engagement partner and all engagement team members who have significant engagement responsibilities. The term "significant engagement responsibilities" should be familiar to auditors because it is already used in AU sec. 316 regarding the appropriate assignment of engagement team members in the overall responses to fraud risks. The proposed standard also contains additional direction regarding multi-location engagements.

The changes to the requirements for engagement team discussions are not intended to substantially change the conduct of these engagement team discussions, except for the inclusion of risks of misstatement due to errors as well as fraud. Rather, the Board is seeking to promote more consistent performance in accordance with the standard.

Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

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[12/] See paragraph A12 of ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment.*

[13/] PCAOB Release 2007-001, "Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud" (January 22, 2007).

RELEASE

AU sec. 316 requires auditors to make inquiries of the audit committee, management and others regarding the risks of material misstatement due to fraud. The proposed standard incorporates those required inquiries and expands the inquiries to cover matters related to risks of material misstatement due to errors or fraud, which the ISA also does.

The proposed standard also specifically requires the auditor to make inquiries of accounting and financial reporting personnel, other than management, who are involved in initiating, authorizing, processing, or recording complex or unusual transactions. The purpose of these inquiries is to obtain the perspectives about risks of material misstatement, particularly fraud risks, from personnel who are directly involved with complex or unusual transactions, which can be more susceptible to misstatement than routine transactions.

Questions

6. Does the proposed standard clearly and adequately describe the auditor's responsibilities for performing risk assessment procedures?

7. Are the additional procedures in paragraph 13 that the auditor should consider performing when obtaining an understanding of the company and its environment reasonable and appropriate for audits of issuers? Should these procedures be specifically required for all audits, or is the responsibility to consider performing the procedures sufficient?

8. Is the new requirement to assess certain matters related to the control environment component of internal control over financial reporting reasonable and appropriate? Is the difference between the required performance for an audit of internal control over financial reporting and an audit of financial statements only clear?

9. Is the additional direction regarding the period-end reporting process reasonable and appropriate for audits of financial statements only?

10. Are the requirements and direction regarding the auditor's responsibilities for evaluating design and implementation of controls as part of obtaining an understanding of internal control over financial reporting sufficient and clear? If not, what additional direction is needed?

11. Does the additional description of the key engagement team members provide a better understanding of the expected participants in the discussion?

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3. Identification and Assessment of the Risks

The proposed standard sets forth a process for identifying and assessing the risks of material misstatement using the information obtained from the risk assessment procedures and other relevant knowledge possessed by the auditor.[14/] The process in the proposed standard is similar to the process for assessing fraud risks that is currently described in AU sec. 316 and the process described in the ISA.

The auditor's identification and assessment of the risks of misstatement provides the basis for identifying –

- Significant accounts and disclosures, and their relevant assertions
- Significant risks

Auditing Standard No. 5 requires the auditor to identify significant accounts and disclosures and their relevant assertions in integrated audits. Also, the interim standards, as amended by the PCAOB, require the auditor to perform substantive procedures for the relevant assertions of significant accounts and disclosures for all audits of financial statements, which would require the auditor to identify those accounts, disclosures, and assertions.[15/] The proposed standard imposes a more explicit requirement to identify significant accounts and disclosures and their relevant assertions.

The proposed standard, like the ISA, imposes a responsibility to determine whether any of the identified risks of material misstatement is a significant risk. Existing PCAOB standards already impose requirements for responding to significant risks.[16/] This proposed standard provides a definition of the term "significant risk" and additional direction for identifying those risks.

The proposed standard carries forward the requirements from AU sec. 316 regarding the presumption that improper revenue recognition is a fraud risk. The proposed standard contains an additional requirement, like the related ISA, for the auditor to evaluate the types of revenue or revenue transactions to which the risk of

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14/ The proposed standard does not include the provision in the interim standards that allowed the auditor to assess risk at the maximum solely for efficiency reasons. Under the proposed standards, the auditor has a responsibility to perform risk assessment procedures that provide an appropriate basis for the risk assessments.

15/ A note to AU sec. 319.02 in the existing standards refers auditors to Auditing Standard No. 5 for direction on identifying relevant assertions.

16/ See, e.g., AU sec. 329.09.

improper revenue recognition relates. This additional requirement should lead auditors to develop appropriate responses based on the nature of the fraud risk.

Question

12. Does the discussion of significant risks in this standard provide sufficient direction to enable auditors to identify significant risks?

4. Documentation

This proposed standard, and the other proposed standards, contain no specific documentation requirements. PCAOB Auditing Standard No. 3, *Audit Documentation,* establishes general requirements for documentation that the auditor should prepare and retain in connection with engagements performed pursuant to the standards of the PCAOB. Paragraph 5a of Auditing Standard No. 3 indicates that the audit documentation should demonstrate that the engagement complied with the standards of the PCAOB. Paragraph 5b of Auditing Standard No. 3 indicates that the audit documentation should support the basis for the auditor's conclusions regarding every relevant financial statement assertion. Paragraph 6 of Auditing Standard No. 3 indicates that the auditor must document the procedures performed, evidence obtained, and conclusions reached regarding relevant financial statement assertions.

The Board believes that Auditing Standard No. 3 imposes sufficient responsibilities on auditors to prepare the necessary documentation in relation to the procedures and other matters covered by the proposed risk assessment standards. For example, in accordance with Auditing Standard No. 3, the auditor's documentation should include documentation of –

- Risk assessment procedures
- A summary of the identified risks and the auditor's assessment of risks at the financial statement and assertion levels and the risks that are determined to be significant risks
- The auditor's responses to the risks of material misstatement, including a summary of the linkage of the assessed risks to the auditor's responses
- A summary of accumulated misstatements and evaluation of uncorrected misstatements

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Public Company Accounting Oversight Board

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- The auditor's conclusions regarding the financial statements and whether the auditor has obtained sufficient appropriate evidence to support his or her opinion on the financial statements.

Accordingly, the Board believes that it is not necessary to prescribe specific documentation requirements.

Question

13. Should the proposed standards include specific requirements and direction regarding documentation, e.g., summaries of the identified and assessed risks and the linkage to the auditor's responses?

Proposed Auditing Standard – The Auditor's Responses to the Risks of Material Misstatement

1. Background

The proposed standard describes the auditor's responsibilities for responding to the risks of material misstatement, including fraud risks, which should be identified in accordance with the proposed standard on identifying and assessing risks of material misstatement.

The PAE Report and PCAOB inspections reports,[17/] among other sources, have cited instances in which the auditors did not perform audit procedures that addressed the risks of material misstatement that they had identified. In developing this standard, the Board seeks to establish requirements and provide direction that will improve auditors' performance in tailoring their audit procedures to address the risks of material misstatement.

2. Types of Responses to the Risks of Material Misstatement

This standard would require the auditor to respond to the risks of material misstatement in two ways –

- Responses that have an overall effect on how the audit is conducted

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[17/] See PCAOB Release 2007-001, "Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud" (January 22, 2007), which states that inspectors had observed instances in which auditors had failed to perform procedures to address identified fraud risks.

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- Responses involving the nature, timing, and extent of the audit procedures to be performed.

Both types of responses are required on all audits. The proposed standard also establishes requirements and provides direction for each type of response.

3. Overall Responses

The proposed standard indicates that the auditor should design and implement overall responses to address the risks of material misstatement in the following areas:

- Making appropriate assignments of significant engagement responsibilities

- Providing an appropriate level of supervision and review of the work of engagement team members

- Incorporating elements of unpredictability in the selection of audit procedures to be performed

- Evaluating the company's selection and application of significant accounting principles

- Making general changes to the nature, timing, or extent of audit procedures

Such responses were required by AU sec. 316 in response to fraud risks, but the proposed standard would expand the requirement to apply to risks of material misstatement due to errors or fraud. The nature of these responses is such that they are appropriate for every audit and may be appropriate for addressing risks of material misstatement due to errors or fraud.

4. Responses Involving the Nature, Timing, and Extent of Audit Procedures

The proposed standard states that auditors should design and perform audit procedures the nature, timing, and extent of which are based on and address the risks of material misstatement for each relevant assertion of each significant account and disclosure.

The proposed standard sets forth three principles that the auditor should follow when designing the audit procedures to respond to the risks of material misstatement. These principles indicate that the auditor's procedures should be –

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- Calibrated to the level of risk
- Tailored to the types of potential misstatements and consistent with the auditor's risk assessments
- In integrated audits, designed to address the objectives of both the audit of internal control over financial reporting and the audit of the financial statements

The auditor’s responsibilities in paragraphs 6, 7a, and 7b of the proposed standard, regarding designing and performing audit procedures that address the risks of material misstatement, are consistent with the principles set forth in AU sec. 312, AU sec. 319, and AU sec. 316. However, the responsibilities as described in the proposed standard are intended to lead auditors to design audit procedures that address more directly the risks of material misstatement identified in their risk assessments.

The audit procedures discussed in this proposed standard include tests of controls and substantive procedures.

Tests of Controls

In all integrated audits, and in many audits of financial statements only, the auditor's response to the risks of material misstatements includes tests of controls. Therefore, this proposed standard includes requirements and direction regarding tests of controls.

Currently, the requirements and direction regarding tests of controls are contained in two separate PCAOB auditing standards. Auditing Standard No. 5 describes the auditor's responsibilities regarding tests of controls in the audit of internal control over financial reporting,[18/] and AU sec. 319 describes the auditor's responsibilities regarding tests of controls in an audit of financial statements.

The proposed standard establishes requirements and provides direction for tests of controls that applies to audits of financial statements only and to integrated audits, in particular, to the financial statement audit portion of the integrated audit. The proposed standard does not change the existing requirements and direction in Auditing Standard No. 5; rather, it articulates the requirements and direction on tests of controls in a manner that aligns more closely with Auditing Standard No. 5. This is intended to, among other things, help auditors design their tests to accomplish the objectives of both

[18/] Paragraphs B1-B9 of Auditing Standard No. 5 also discuss the integration of the testing of controls in the audit of internal control over financial with testing of controls in the audit of financial statements.

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the audit of the financial statements and the audit of internal control over financial reporting.

The requirements and direction regarding tests of controls in the proposed standard was developed primarily from the corresponding direction from Auditing Standard No. 5. In the Board's view, the basic principles for designing and performing tests of controls are the same for the audit of internal control over financial reporting and the audit of the financial statements. The primary differences relate to the objectives of the testing, the principles for selecting controls to test, the timing of testing, and the amount of evidence needed from the tests. Paragraphs 14-16 of the proposed standard discuss the objective of tests of controls in the audit of internal control over financial reporting and the key principles for selecting controls to test and determining the evidence needed regarding control effectiveness. Paragraphs 17-20 discuss the objective of tests of controls in the audit of financial statements and the key principles for selecting controls to test and determining the evidence needed regarding control effectiveness. Paragraphs 21-22 discuss testing the design and operating effectiveness of controls, and those paragraphs apply to both the audit of internal control over financial reporting and the audit of financial statements, except where indicated otherwise. Paragraphs 38-39 then establish requirements and provide direction regarding assessing control risk in the audit of financial statements. For an audit of financial statements only, the auditor would follow the requirements and direction in Paragraphs 17-39 except for those requirements that are identified as applying only to the audit of internal control.

This proposed standard and Auditing Standard No. 5 indicate that, when the auditor relies on controls in the audit of the financial statements, he or she should test controls over the period of reliance. Footnote 13 of the proposed standard defines the term "period of reliance" as "the period being covered by the company's financial statements, or the portion of that period, for which the auditor plans to rely on controls in order to modify the nature, timing, and extent of planned substantive procedures."

Questions

14. Does the proposed standard clearly describe the auditor's responsibilities regarding tests of controls in integrated audits and in audits of financial statements only?

15. Are the requirements and direction regarding tests of controls appropriately aligned with Auditing Standard No. 5?

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Substantive Procedures

The proposed standard would retain the requirement in existing PCAOB standards[19/] that auditors perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.

The proposed standard sets forth principles for determining the appropriate nature, timing, and extent of substantive procedures. Although these principles are consistent with the existing PCAOB standards, the proposed standard provides additional direction that is intended to lead auditors design audit procedures that are based on and that address the risks of material misstatement.

For significant risks, the proposed standard on the auditor's response would require the auditor to perform substantive procedures that are specifically responsive to the risks. Existing PCAOB standards[20/] indicate that it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient responses to significant risks. Consistent with these principles, the proposed standard indicates that the substantive procedures that address significant risks should include tests of details.

The proposed standard carries forward the basic principles in AU sec. 313 regarding performing substantive procedures as of an interim date and the intervening period through year-end. However, the formulation of these requirements has been revised to align more closely with the risk-based principles in the remainder of this standard.

Question

16. Does the proposed standard clearly describe the auditor's responsibilities regarding substantive procedures?

Responses to Fraud Risks

In existing PCAOB standards, AU sec. 316 describes the auditor's responsibilities for responding to fraud risks in the audit of financial statements. Those responses include certain overall responses and certain specific responses involving the nature, timing, and extent of audit procedures. The proposed standard carries forward the key principles from AU sec. 316 for responding to fraud risks. For example, the proposed standard includes the same overall responses as AU sec. 316, although it

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19/ AU sec. 319.02.

20/ AU sec. 329.09.

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broadens certain of those requirements to apply to risks of material misstatement due to errors or fraud. Under the proposed standard, the general principles for responses involving audit procedures also apply to responses to fraud risks. In addition, the proposed standard states that the auditor should perform procedures, including tests of details, that are specifically responsive to the fraud risks. This requirement is drawn from the requirements for responding to significant risks because the proposed standard on identifying and assessing risks of material misstatement indicates that fraud risks are significant risks. This statement is also consistent with the principle in the AU sec. 329.10 that substantive analytical procedures alone are not well suited to detecting fraud. The remaining direction regarding responding to fraud risks carries forward key principles from AU sec. 316 and references AU sec. 316 for further direction regarding those responses.

Proposed Auditing Standard – Evaluating Audit Results

1. Background

This proposed standard describes the auditor's responsibilities regarding the process of evaluating the results of the audit in order to form the opinion(s) to be presented in the auditor's report. The proposed standard would consolidate into one standard the requirements and direction that currently are included in five separate auditing standards[21/] to better highlight matters that are important to the auditor's conclusions about the financial statements and the effectiveness of internal control over financial reporting.

2. Evaluating the Results of the Audit of Financial Statements

Under the proposed standard, the auditor's evaluation of the audit results would encompass the following:

- The results of analytical procedures in the overall review of the financial statements,
- Identified misstatements,

21/ AU sec. 312, regarding evaluating audit results, including uncorrected misstatements; AU sec. 316, regarding fraud considerations that are relevant to evaluating audit results; AU sec. 329, regarding performing the overall review; AU sec. 319 regarding the relationship of audit evidence obtained on control risk assessments; and Auditing Standard No. 5, regarding the evaluating the results of the audit of internal control and the effect of the results of the audit of internal control on the financial statement audit.

- The qualitative aspects of the company's accounting practices,

- Conditions identified during the audit that relate to the assessment of the risk of material misstatement due to fraud ("fraud risk"),

- The presentation of the financial statements, including disclosures, and

- The sufficiency and appropriateness of the audit evidence obtained.

3. Performing Analytical Procedures in the Overall Review

The proposed standard retains the requirements in AU secs. 316 and 329 to read the financial statements and disclosures and perform analytical procedures in the overall review. The conclusions formed from the results of the overall review of the audit are intended to corroborate conclusions formed during the audit of individual accounts and disclosures.

While performing the overall review, the auditor might discover unusual or unexpected transactions, events, or amounts or analytical relationships that indicate risks of material misstatements that were not identified previously and for which the audit procedures need to be modified or additional procedures need to be performed. Some unusual or unexpected analytical relationships might have been identified and might indicate a fraud risk because management or employees generally are unable to manipulate certain information to create seemingly normal or unexpected relationships, such as the following:

- The relationship of net income to cash flows from operations might appear unusual because management recorded fictitious revenues and receivables but was unable to manipulate cash.

- Changes in inventory, accounts payable, sales, or cost of sales from the prior period to the current period may be inconsistent, indicating a possible employee theft of inventory, because the employee was unable to manipulate all of the related accounts.

- A comparison of the entity's profitability to industry trends, which management cannot manipulate, may indicate trends or differences for further consideration when identifying risks of material misstatements due to fraud.

- A comparison of bad debt write-offs to comparable industry data, which employees cannot manipulate, might provide unexplained relationships that could indicate a possible theft of cash receipts.

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- An unexpected or unexplained relationship between sales volume as determined from the accounting records and production statistics maintained by operations personnel, which might be more difficult for management to manipulate, might indicate a possible misstatement of sales.

The proposed standard also requires the auditor to evaluate whether management's responses to the auditor's inquiries about significant unusual or unexpected trends or relationships have been vague, implausible, or inconsistent with other audit evidence and perform procedures as necessary to address the matter.

4. Accumulating and Evaluating Identified Misstatements

Accumulating Identified Misstatements

The proposed standard indicates that the auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial.[22/] The threshold for misstatements that are clearly trivial should be set so that any misstatements below that amount are not material to the financial statements, individually or in combination with other misstatements, considering the possibility of undetected misstatements. Accordingly, the threshold for clearly trivial amounts should be substantially less than tolerable misstatement or the materiality levels established for planning and performing the audit.

AU sec. 312.34 classifies misstatements into two categories – known (misstatements specifically identified during the audit) and likely (the auditor's best estimate of misstatements in an assertion), and states that auditors should accumulate likely misstatements. The proposed standard retains the principle that the auditor should accumulate his or her best estimate of the misstatement in the accounts that he or she has tested without using the terms "known misstatement" and "likely misstatement." Instead, the proposed standard indicates that the auditor should consider distinguishing the misstatements among specifically identified misstatements, projected misstatements from substantive audit sampling and misstatements related to accounting estimates. Distinguishing the types of misstatements can be useful for evaluating the uncorrected misstatements or for communicating the misstatements to the audit committee. For example, a projected misstatement from an audit sampling method provides an indication of the amount of potential misstatement in the sample population, but additional examination might be necessary to determine the necessary corrections to the financial statements. Also, misstatements related to accounting estimates might be useful when evaluating the potential for bias in other accounting estimates.

[22/] The proposed standard uses the term "clearly trivial," the term used in the IAASB standard, rather than "clearly inconsequential," the term used in the interim standards. The meaning of the two terms is the same.

PCAOB
Public Company Accounting Oversight Board

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Evaluating the Effect of Uncorrected Misstatements

The proposed standard indicates that the auditor should evaluate the uncorrected misstatements in relation to accounts and disclosures and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.[23/]

Prior Period Misstatements

The proposed standard states that the auditor should evaluate the effect of prior period uncorrected misstatements on the current period financial statements. Like the existing standard, the proposed standard does not address how to evaluate the effect of prior period misstatements because that is an accounting and financial reporting matter.[24/]

Fraud Risk Considerations

The proposed standard requires the auditor to evaluate whether identified misstatements might indicate fraud. It also includes a new requirement from the ISAs to evaluate circumstances or conditions, which might indicate collusion involving employees, management or external parties when evaluating the reliability of audit evidence.

5. Evaluating the Qualitative Aspects of the Company's Accounting Practices

The proposed standard requires the auditor to evaluate the qualitative aspects of company's accounting practices, including the possibility of management bias in matters such as:

- Selective correction of misstatements
- Selection and application of accounting principles
- Development of accounting estimates

The proposed standard also describes the auditor's responsibilities in situations in which bias exists. AU sec. 316 provides direction on specific aspects of evaluating bias of accounting estimates and selection and application of accounting principles, but

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[23/] The SEC staff has provided guidance in Staff Accounting Bulletin No. 99 on the effects of qualitative factors on the evaluation of uncorrected misstatements.

[24/] For example, the SEC staff has provided guidance in Staff Accounting Bulletin No. 108 on the effects of prior year misstatements when quantifying misstatements in the current year financial statements.

RELEASE

this requirement in the proposed standard imposes a broader responsibility to evaluate the potential effect of management bias on the financial statements. The ISAs have similar requirements.

6. Evaluating Conditions That Relate to the Assessment of Fraud Risks

Appendix A of the proposed standard describes certain conditions that might affect the assessment of fraud risks if identified during the audit. Most of the conditions are carried forward from AU sec. 316, but the list of conditions has been expanded to include the following items from the ISA that also warrant consideration by the auditor:

- Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships – for example, receivables growing faster than revenues
- Large numbers of credit entries and other adjustments made to accounts receivable records
- Unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statement and the accounts receivable sub-ledger
- Missing or non-existent cancelled checks in circumstances in which cancelled checks are ordinarily returned to the company with the bank statement
- Fewer responses to confirmation requests than anticipated or a greater number of responses than anticipated
- An unwillingness to appropriately address significant deficiencies in internal control on a timely basis
- Unwillingness by management to permit the auditor to meet privately with the audit committee
- Accounting policies that appear inconsistent with industry practices that are widely recognized and prevalent
- Frequent changes in accounting estimates that do not appear to result from changing circumstances
- Tolerating violations of the company's code of conduct

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The auditor's identification of one or more conditions presented in Appendix A does not necessarily mean that fraud exists. However, the auditor has a responsibility to determine whether the conditions that are identified during the audit affect the assessment of fraud risks. The Board seeks comment on whether the list of conditions in Appendix A and the accompanying direction are reasonable and appropriate, and, in particular, whether there are conditions in Appendix A that should be added, removed, or modified.

7. Evaluating the Sufficiency and Appropriateness of Audit Evidence

PCAOB standards require the auditor to obtain sufficient competent evidence to obtain reasonable assurance in order to express the opinion(s) in the audit report, and the standard auditor's report includes a representation about the sufficiency of the auditor's work. The proposed standard specifically requires the auditor to evaluate whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements, and the standard provides direction on the matters to be considered during this evaluation.

8. Evaluating the Results of an Integrated Audit

The proposed standard describes the auditor's responsibilities for evaluating audit results in an integrated audit as well as in an audit of financial statements only. Specifically, the standard addresses how, in integrated audits, the evaluation of the results of the audit of internal control affects the auditor's conclusions in the audit of the financial statements and vice versa. It also summarizes key principles of the evaluation of audit results in the audit of internal control, in which case the proposed standard references, but does not repeat, the relevant requirements and direction from Auditing Standard No. 5 regarding evaluating the severity of control deficiencies.

Questions

17. Does the proposed standard clearly describe the auditor's responsibilities regarding the evaluation of audit results?

18. Are the requirements and direction regarding the accumulating identified misstatements and evaluating uncorrected misstatements appropriate and adequate?

19. Are the requirements and direction regarding the evaluation of the results of the integrated audit appropriately aligned with Auditing Standard No. 5?

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Proposed Auditing Standard – Consideration of Materiality in Planning and Performing an Audit

1. Background

This proposed standard describes the auditor's responsibilities regarding the consideration of materiality in planning and performing an audit.[25/]

The concept of materiality is articulated in the federal courts' interpretations of the federal securities laws. In developing this proposed standard, the Board sought to describe the auditor's responsibilities for appropriately applying the concept of materiality in planning and performing audit procedures.

The requirements and direction in the existing PCAOB standards regarding the auditor's consideration of materiality is set forth primarily in AU sec. 312, *Audit Risk and Materiality in Conducting an Audit.* The auditor's responsibilities under the proposed standard are fundamentally the same as in the interim AU sec 312. However, the proposed standard contains some additional direction, as described in the following paragraphs.

2. Applying the Concept of Materiality in Planning and Performing the Audit

The auditor's responsibilities for applying the concept of materiality as described in this standard are based on the principle that, to obtain reasonable assurance about whether the financial statements are free of material misstatement, the auditor should design and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements.

The proposed standard establishes responsibilities for the auditor to –

1. establish an appropriate materiality level for the financial statements as a whole

2. establish a lower materiality level or levels for particular accounts or disclosures when necessary

3. determine an amount or amounts of "tolerable misstatement," which are lower than the preceding amounts and which are used for determining the scope of audit procedures

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[25/] This standard is closely related to the proposed standard on evaluating audit results, which, among other things, establishes requirements and provides direction on the auditor's consideration of materiality in evaluating uncorrected misstatements identified during the audit.

RELEASE

AU secs. 312.14 and 312.19, in effect, establish a responsibility for the auditor to "make a preliminary judgment" about materiality when planning the audit. The proposed standard indicates that the auditor should establish an appropriate materiality level for the financial statements as a whole. This materiality level should be established in light of the surrounding circumstances.[26/] For example, if a company's net earnings were the most important factor in the total mix of information available to a reasonable investor, then the company's earnings should be taken into account in establishing the materiality level for the financial statements taken as a whole. On the other hand, financial statement elements other than net earnings might be more important to a reasonable investor depending on the company's industry or operations, e.g., if the company has a nominal net income or loss.

AU sec. 312.14 indicates that the auditor's preliminary judgment about materiality need not be quantified. As a practical matter, many of the auditor's decisions involving planning the scope of the audit are quantitative, e.g., decisions about the extent of audit procedures. Accordingly, the proposed standard includes a statement that, in planning the audit, the auditor's materiality level for the financial statements as a whole needs to be expressed as a specified amount.

AU sec. 312.20 discusses the consideration of qualitative factors affecting materiality in planning and performing an audit. The proposed standard includes similar direction. The proposed standard indicates that the auditor should be alert for misstatements that could be qualitatively material and should evaluate uncorrected misstatements based on qualitative factors, but that ordinarily it is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors. This statement acknowledges that, as a practical matter, the auditor typically obtains information about qualitative factors affecting materiality through the procedures performed during the audit, e.g., information about the nature and cause of misstatements identified during the audit.

AU sec. 312.19 discusses establishing an overall materiality level based on the smallest aggregate level of misstatement that would be considered material to any of the individual financial statements. The proposed standard establishes a responsibility for the auditor to consider whether, for particular accounts or disclosures, misstatements in amounts less than the materiality level for the financial statements as a whole could influence the judgment of a reasonable investor. In those circumstances,

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[26/] See, e.g., Financial Accounting Standards Board Statement of Financial Accounting Concepts ("FASB Concepts Statement") No. 2, *Qualitative Characteristics of Accounting Information*. The Financial Accounting Standards Board has proposed a new Statement of Financial Accounting Concepts that would supersede FASB Concepts Statement No. 2. The Board will consider the status of the relevant FASB Concepts Statement in future deliberations of this proposed auditing standard.

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the auditor is required to establish separate materiality levels for such accounts or disclosures. The formulation in the proposed standard is more consistent with the principle of considering the perceptions of investors when making materiality judgments because it recognizes that, in certain circumstances, misstatements in some accounts might have more significant consequences than in other accounts.

The following are examples of situations in which a lower materiality threshold might be needed:

- Laws, regulations, or the applicable financial reporting framework affect investors' expectations about the measurement or disclosure of certain items, e.g., related party transactions and compensation of senior management.

- Significant attention has been focused on a particular aspect of a company's business that is separately disclosed in the financial statements, e.g., a recent business acquisition.

- Certain disclosures are particularly important to investors in the industry in which the company operates.

AU sec. 312.25 provides direction on applying auditor judgments about materiality to the determination of the scope of the audit procedures at the account level. In the proposed standard, this is addressed through the direction regarding tolerable misstatement.

To relate the auditor's materiality judgments to individual accounts and disclosures, the proposed standard indicates that the auditor should determine the amount or amounts of tolerable misstatement for purposes of assessing risks and planning and performing audit procedures. Tolerable misstatement is less than the materiality levels discussed in the preceding paragraphs because tolerable misstatement takes into account the amount of expected misstatement in the accounts as well as the amount of the possible undetected misstatement. The expectations about misstatement in the accounts and disclosures should be informed by the auditor's risk assessment procedures and other relevant information about the company and the respective accounts and disclosures, including the nature, cause and amount of misstatements identified in audits of prior periods.

<u>Questions</u>

20. Are the requirements and direction in this standard appropriately aligned with the concept of materiality as described in the courts' interpretation of the federal securities laws?

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21. Does the proposed standard sufficiently and clearly describe the auditor's responsibilities regarding (a) establishing an appropriate materiality level for the financial statements as a whole and (b) establishing a lower materiality level or levels for particular accounts or disclosures? If not, what additional direction is needed?

22. Is the use of the term "tolerable misstatement" in the proposed standard appropriate and sufficiently clear?

<u>Proposed Auditing Standard – Audit Evidence</u>

1. Background

This proposed standard would establish requirements and provide direction regarding the use of audit evidence and designing and performing audit procedures to obtain sufficient appropriate audit evidence.

The proposed standard would supersede AU sec. 326, *Audit Evidence.* The most significant differences between the proposed standard and AU sec. 326 relate to –

- Terminology
- Enhancements to the direction regarding relevance and reliability of audit evidence
- Additional direction regarding specific audit procedures
- Additional direction regarding selection of items for testing

2. Sufficient Appropriate Audit Evidence

The proposed standard explains the meaning of "sufficient" and "appropriate" as used in the phrase "sufficient appropriate audit evidence." The proposed standard also sets forth principles for evaluating the sufficiency and appropriateness of audit evidence, which auditors should take into account in determining the necessary nature, timing, and extent of their audit procedures.

AU sec. 326 refers to obtaining sufficient competent audit evidence. The proposed risk assessment standards use the word "appropriate" rather than "competent" to follow the terminology in the ISA. The proposed standard describes the term "appropriate" as evidence that is both "relevant" and "reliable." The proposed standard also provides direction to auditors on determining the relevance and reliability

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of audit evidence. AU sec. 326 provides no direction on assessing the relevance of audit evidence. The proposed standard's discussion regarding reliability covers two additional matters that are not addressed in AU sec. 326:

- The use of original documents rather than photocopies, facsimiles or electronic versions of documents.
- A responsibility regarding considering the reliability of documents and performing additional procedures if conditions indicate that a document might not be authentic or might have been altered. This is a more direct description of the auditor's responsibilities than the interim standards.

Questions

23. Does the proposed standard clearly describe the principles necessary for evaluating the sufficiency, relevance, and reliability of audit evidence?
24. Are the auditor's responsibilities regarding the authentication of documents reasonable and appropriate?
25. Are the requirements and direction related to selecting items for testing appropriate and clear?

3. Use of Assertions in Obtaining Audit Evidence

Financial statement assertions are an important consideration for audits performed in accordance with PCAOB standards. For example, both existing PCAOB standards and the proposed risk assessment standards require auditors to:

- Perform substantive procedures for the relevant assertions of the significant accounts and disclosures in audits of financial statements; and
- Obtain evidence about the design and operating effectiveness of selected controls over relevant assertions of significant accounts and disclosures in audits of internal control over financial reporting.

This proposed standard explains what financial statement assertions are and describes five categories of financial statement assertions, which is consistent with AU sec. 326 and Auditing Standard No. 5. The proposed standard allows auditors to use categories of assertions that differ from the assertions listed in this standard under certain specified conditions. The requirements and direction regarding financial

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RELEASE

statement assertions in this proposed standard are consistent with the requirements in existing PCAOB standards.

Question

26. Are the five categories of assertions in this standard sufficient or should they be expanded? If so, how would such expansion affect auditor performance?

4. Direction Regarding Types of Audit Procedures

The proposed standard provides more details about the purpose and nature of specific types of audit procedures than is provided in AU sec. 326. Although this additional discussion is new to the evidence standard, it is consistent with respective discussion in other PCAOB standards. Presenting this additional information in the evidence standard can help auditors in determining the nature of their audit procedures.

5. Selecting Items for Testing

The proposed standard contains a section on selecting items for testing. Currently, this topic is covered in an auditing interpretation to AU sec. 350, *Audit Sampling.*[27/] The interpretation discusses the subject in the context of audit procedures that do not involve audit sampling, while the proposed standard establishes an overall principle for selecting items for testing and discusses the use of the alternative selection methods.

6. Other Changes

Certain topics that appear in AU sec. 326 are omitted from the proposed standard. AU sec. 326 discusses the use of audit objectives, and an appendix to that standard illustrates how auditors might use assertions to develop audit objectives and substantive tests of inventory. Such a discussion is not necessary because the auditing standards do not require auditors to establish audit objectives to link assertions to substantive procedures. However, omission of this direction would not preclude auditors from using audit objectives in designing their audit procedures.

[27/] AU sec. 9350, *Audit Sampling: Auditing Interpretations of AU sec. 350.*

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Section-by-Section Description of Proposed Conforming Amendments to PCAOB Auditing Standards

The following section of this appendix discusses the nature of the proposed conforming amendments to PCAOB standards.

Proposed Conforming Amendments to Auditing Standard No. 3

Paragraph A37 of Auditing Standard No. 3 contains a quote from AU sec. 326.25, which would be replaced with a similar quote from the proposed standard on evaluating audit results.

Proposed Conforming Amendments to Auditing Standard Nos. 4 and 5

The proposed conforming amendments to Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist,* and Auditing Standard No. 5 are limited to changing the word "competent" to "appropriate," when that word is used in reference to audit evidence and updating references to auditing standards that are being superseded or amended.

Proposed Conforming Amendments to Interim Auditing Standards

Superseded Sections

The proposed auditing standards would supersede the following sections of PCAOB interim auditing standards:

- AU sec. 311, *Planning and Supervision*
- AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*
- AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date*
- AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*
- AU sec. 326, *Evidential Matter*

Similarly, the auditing interpretations of AU secs. 311, 312, and 350 have been incorporated into the proposed auditing standards and thus would be superseded.

RELEASE

AU sec.316, Consideration of Fraud in a Financial Statement Audit

As discussed previously, the relevant requirements and direction regarding identifying and assessing fraud risks, responding to fraud risks and evaluating audit results have been incorporated into the proposed risk assessment standards. The remaining portions of AU sec. 316 describe important principles regarding the auditor's responsibility with respect to fraud and more detailed requirements and direction regarding the auditor's responses to fraud risks.

The relevant requirements and direction regarding identifying and assessing fraud risks, principally AU sec. 316.14- .45; responding to fraud risks, principally AU sec. 316.46 - .51; and evaluating audit results, principally, AU secs. 316.68-.78; have been incorporated into the proposed risk assessment standards. The remaining portions of AU sec. 316 describe important principles regarding the auditor's responsibility with respect to fraud and more detailed requirements and direction regarding the auditor's responses to fraud risks. The amendments to AU sec. 316 provide an overview of the auditor's consideration of fraud and, where applicable, references to the appropriate requirements and direction in the proposed standards.

AU sec. 329, Analytical Procedures

The discussion in this interim standard regarding analytical procedures performed during audit planning, principally paragraphs AU secs. 329.03, and 329.06-..08, are incorporated into Proposed Auditing Standard, I*dentifying and Assessing Risks of Material Misstatement*. Similarly, the requirements and direction regarding analytical procedures in the overall review, principally AU secs. 329.23 - 24, are incorporated into Proposed Auditing Standard, *Evaluating Audit Results*. The remaining portion of this standard relates to analytical procedures performed as substantive procedures. Therefore, this standard would be re-titled as *Substantive Analytical Procedures,* which more accurately reflects the content of the amended standard.

A standard that focuses solely on substantive analytical procedures would highlight more clearly the requirements that apply to analytical procedures performed for that purpose. Inspections teams have observed instances in which auditors performed substantive procedures to test accounts without meeting the requirements in AU sec. 329 for substantive analytical procedures.[28/]

[28/] See, e.g., PCAOB Release 2007-010, "Report on the PCAOB's 2004, 2005 and 2006 Inspections of Domestic Triennially Inspected Firms" (October 22, 2007).

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AU sec. 350, Audit Sampling

The discussion in AU sec. 350 regarding audit risk and tolerable misstatement have been amended to align more closely with the proposed standards. In particular, AU secs. 350.23 and 350.38 have been amended to explain more specifically how the principles in the standard for determining sample sizes when nonstatistical sampling approaches are used.

Other Conforming Amendments to the Interim Auditing Standards

For the following interim auditing standards, the proposed amendments are limited to changing the word "competent" to "appropriate," when that word is used in reference to audit evidence, and/ or updating references to auditing standards that are being superseded or amended:

- AU sec. 110, *Responsibilities and Functions of the Independent Auditor*
- AU sec. 150, *Generally Accepted Auditing Standards*
- AU sec. 230, *Due Professional Care in the Performance of Work*
- AU sec. 310, *Appointment of the Independent Auditor*
- AU sec. 315, *Communications between Predecessor and Successor Auditors*
- AU sec. 317, *Illegal Acts by Clients*
- AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.*
- AU sec. 324, *Service Organizations*
- AU sec. 328, *Auditing Fair Value Measurements and Disclosures*
- AU sec. 330, *The Confirmation Process*
- AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*
- AU sec. 333, *Management Representations*

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- AU sec. 334, *Related Parties* and AU sec. 9334*, Related Parties :Auditing Interpretations of Section 334*
- AU sec. 336, *Using the Work of a Specialist* and AU sec. 9336, *Using the Work of a Specialist: Auditing Interpretation of 336*
- AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a* Going *Concern*
- AU sec. 342, *Auditing Accounting Estimates* and AU 9342, *Auditing Accounting Estimates : Auditing Interpretation of 342*
- AU sec. 411, *The Meaning of Presented Fairly in Conformity with Generally Accepted Accounting Principles*
- AU sec. 508, *Reports on Audited Financial Statements* and AU sec. 9508*, Reports on Audited Financial Statements: Auditing Interpretations of Section 508*
- AU sec. 530, *Dating of the Independent Auditor's Report*
- AU sec. 623, *Special Reports*
- AU sec. 722, *Interim Financial Information*
- AU sec. 901, *Public Warehouses – Controls and Auditing Procedures for Goods Held*

Also, footnote 4 to paragraph .16 of AU sec. 9543*, Part of Audit Performed by Other Independent Auditors: Auditing Interpretation of Section 543,* was deleted because it refers to an interim standard that was superseded.

Proposed Conforming Amendments to Interim Ethics Standards

In the interim ethics standard, ET sec. 102, *Integrity and Objectivity,* the proposed conforming amendments are limited to updating references to auditing standards that are being superseded or amended.

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APPENDIX 10

Comparison of Requirements to the Standards of the International Auditing and Assurance Standards Board[1/]

The proposing release discusses the Board's approach to considering the International Standards on Auditing ("ISAs") of the International Auditing and Assurance Standards Board ("IAASB") in developing the proposed standards. The following paragraphs discuss significant differences between the requirements of the proposed PCAOB standards and the requirements of the respective ISAs.

Proposed Auditing Standard – Audit Risk in an Audit of Financial Statements

The provisions of this standard are similar to the discussion of audit risk included in ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.*

Proposed Auditing Standard – Audit Planning and Supervision

The respective IAASB standard for audit planning is ISA 300, *Audit Planning.*

The responsibility in paragraph 7 of the proposed standard to consider the importance of certain matters and how they affect the audit strategy and audit plan is unique to PCAOB standards.

The proposed standard carries forward the requirements and direction in AU sec. 312.18 regarding multi-location engagements, with a few changes to align it more closely with the related direction in Auditing Standard No. 5. The IAASB's primary direction regarding multi-location engagements is set forth in ISA 600 on group audits. Providing direction on group audits is beyond the scope of these proposed standards.

As discussed in Appendix 9, the proposed standard retains, without significant re-evaluation, the requirements regarding supervision from AU sec. 311 of the interim standards. Accordingly, a detailed comparison of existing PCAOB requirements for supervision with those of the ISAs was not necessary.

[1/] The Board understands that the Auditing Standards Board is in the process of updating its risk assessment standards as part of their clarity project. Therefore, this appendix compares the proposed standards only to the standards of the IAASB.

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Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement

ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment,* and ISA 240, *The Auditor's Responsibilities Relating to Fraud in An Audit of Financial Statements,* are the respective IAASB's auditing standards regarding identifying and assessing the risks of material misstatement. The following paragraphs discuss differences between the requirements in the proposed standard and those in ISA 315 and ISA 240 where applicable.

The proposed standard is applicable to both the audit of internal control over financial reporting and the audit of the financial statements. Paragraph 7 of the proposed standard indicates that the auditor's risk assessment procedures should apply to both audits. ISA 315 applies only to audits of financial statements and, accordingly, there is no such requirement. Consequently, the requirements that are specific to audits of internal control, such as that in paragraph 24 of the proposed standard, are unique to the proposed standard.

The requirement in the proposed standard to obtain an understanding of how changes in the company from prior periods affect risks of material misstatements is presented in ISA 315 as application material rather than a requirement in the ISA.

Paragraph 13 of the proposed standard presents a list of additional audit procedures that the auditor should consider performing while obtaining an understanding of the company and its environment. ISA 315 has no such requirement, although the ISA 315 application material cites reviewing information obtained from external sources, such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications as a procedure that might be helpful in identifying risks of material misstatement.

Both the proposed standard and ISA 315 require auditors to obtain an understanding of the company's selection and application of accounting principles. The proposed standard includes a list of matters that the auditor should understand in relation to the company's selection and application of accounting principles, which generally is consistent with the matters listed in the application material of ISA 315. The proposed standard includes three additional matters relating to the accounts or disclosures in which judgment is used in the application of significant accounting principles, the degree of transparency of the application of significant accounting principles, and the financial reporting competencies of personnel involved in selecting and applying new or complex accounting principles.

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In obtaining an understanding of the control environment, ISA 315 requires the auditor to evaluate whether (a) management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and (b) the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by control environment weaknesses. The proposed standard requires an additional assessment related to the control environment, but the requirement is aligned more closely with Auditing Standard No. 5.

The proposed standard and ISA 315 both require the auditor to obtain an understanding of the company's risk assessment process as part of obtaining an understanding of internal control. ISA 315 contains additional requirements for situations in which the company has no formal risk assessment process or a lack of documentation regarding the process. The proposed standard does not include these additional requirements because it is not necessary for the standards of audits of issuers to impose specific requirements based on the level of formality or documentation of the risk assessment component of internal control over financial reporting.

The proposed standard provides direction regarding the persons who should participate in the discussion among engagement team members about the risks of material misstatement, and such direction is not included in ISA 315. Also, the proposed standard carries forward the requirements in AU sec. 316 regarding the topics to be included in the discussion of fraud risks. ISA 240 provides guidance about topics to be discussed primarily in the application material.

ISA 315 requires the risk assessment procedures to include inquiries of management and others, analytical procedures, and observation and inspection. The proposed standard does not include this requirement. Rather, the requirements in the proposed standard, by their nature, should lead the auditor to perform a combination of those types of procedures.

The proposed standard and ISA 315 require the auditor to obtain an understanding of internal control. The proposed standard also indicates that the understanding should be sufficient to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures. ISA 315 does not have similar direction with respect to the sufficiency of the auditor's understanding of internal control over financial reporting.

The proposed standard retains the requirement from AU section 316.29 to perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a

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RELEASE

material misstatement due to fraudulent financial reporting. The ISAs do not include this requirement.

In the requirements regarding the assessment of identified risks of material misstatement, the proposed standard directs the auditor to evaluate whether the risks of material misstatement at the financial statement level could result in risks of material misstatement at the assertion level. Also, the proposed standard requires auditors to identify significant accounts and disclosures and their relevant assertions. ISA 315 does not include these requirements.

The proposed standard does not include the appendix in ISA 315, containing descriptions of the components of internal control over financial reporting and examples of conditions and events that could indicate risks of misstatement. Instead, auditors should refer to the applicable internal control framework for information about internal control components.

Similarly, the proposed standard does not include the appendix in ISA 315 that lists risk indicators because the Board believes that auditors should focus on the risks that are relevant to the particular company rather than a generalized list of risk factors.

Proposed Auditing Standard – The Auditor's Responses to the Risks of Material Misstatement

ISA 330, *The Auditor's Responses to Assessed Risks,* is the IAASB's auditing standard regarding the auditor's responses to risks of material misstatement. The following paragraphs discuss differences between the requirements in the proposed standard and those in ISA 330.

One important difference between the requirements of the proposed standard and those of the ISA is that the proposed standard contains key principles for responding to the risks of material misstatements in an integrated audit. For example, paragraph 7c of the proposed standard directs the auditor to design tests of controls to meet the objectives of both the audit of financial statements and the audit of internal control over financial reporting. ISA 330 addresses only audits of financial statements.

Another difference is that the ISA refers to the auditor's responses to "assessed" risks, whereas the proposed standard refers to responses to the risks of material misstatement. In the Board's view, obtaining sufficient appropriate evidence to support the auditor's opinion requires the auditor to adequately respond to the risks of material misstatement, and this principle is separate from, but related to, the appropriateness of the auditor's risk assessments. The Board recognizes that if the auditor appropriately identifies and assesses the risks of material misstatement in accordance with the proposed standard on indentifying and assessing risks, then the auditor is in a better

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Public Company Accounting Oversight Board

RELEASE

position to respond to the risks. On the other hand, noncompliance with the proposed standard on identifying and assessing risks that leads to a failure to identify or appropriately assess a risk of material misstatement also could result in a failure to appropriately respond to the risk of material misstatement in accordance with the proposed standard on auditor's responses.

ISA 330 indicates that the auditor implements overall responses to address risks at the financial statement level and responses involving the nature, timing, and extent of audit procedures to address risks at the assertion level. The Board believes that it is more important for the auditor to design and implement appropriate responses to the risks of material misstatement than to match the form of response to whether the risk is classified as a financial statement level risk or assertion level risk. Therefore, the proposed standard does not require the auditor to match overall responses to financial statement level risks and responses involving audit procedures to assertion level risks. Instead, the standard imposes a responsibility on the auditor to design and implement overall responses and responses involving audit procedures that address the risks of material misstatement. The proposed standard does not preclude the auditor from using overall responses to address risks at the financial statement level if those responses appropriately address the risks. However, an auditor cannot avoid performing audit procedures necessary to address a risk of material misstatement merely because the risk exists at the financial statement level.

In the direction on performing substantive procedures in response to significant risks, the proposed standard indicates that the substantive procedures should include tests of details. ISA 330 allows the auditor to address significant risks through a combination of tests of controls and substantive analytical procedures as an alternative to substantive tests of details.

As discussed previously, the requirements and direction regarding tests of controls in the proposed standard are aligned closely with the other risk assessment standards and Auditing Standard No. 5. Thus, the description of the requirements and direction in the proposed standard differs in some respects from the respective requirements and guidance in ISA 330. One significant procedural difference between the proposed standard and ISA 330 is that that ISA allows the auditor to use evidence from prior audits about operating effectiveness of controls without retesting, subject to certain conditions and limitations set forth in the standard. Like Auditing Standard No. 5, the proposed standard requires auditors to obtain evidence about controls selected for testing each year. However, the proposed standard contains direction for using evidence obtained in prior audits and varying the amount of evidence obtained based on factors set forth in the proposed standard.

Also, paragraph 49 of the proposed standard, which describes the auditor's responsibilities regarding performing substantive procedures before the end of the period, requires the auditor to compare relevant information about the account balance

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at the interim date with comparable information at the period end and to perform audit procedures to test the remaining period between the interim testing date and year end. ISA 330 imposes requirements for covering the remaining period, but the procedures involving comparing relevant information at the interim date to period-end information is included in the application material of the standard.

Proposed Auditing Standard – Evaluating Audit Results

The respective requirements in the ISAs relevant to the evaluation of audit results are –

- ISA 450, *Evaluation of Misstatements Identified During an Audit*
- ISA 330, *The Auditor's Responses to Assessed Risks*
- ISA 520, *Analytical Procedures*
- ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

The following paragraphs discuss differences between the requirements of the proposed standard and the respective requirements of the ISAs.

The proposed standard discusses the auditor's responsibilities for evaluating the results of integrated audits as well as audits of financial statements only. It discusses how the results of the audit of internal control can affect the evaluation of the results of the financial statement audit and vice versa.

ISA 450, paragraph A3, indicates that to assist the auditor in evaluating the effect of accumulated misstatements and communicating them to management and the audit committee, it may be useful to distinguish between factual misstatements, judgmental misstatements, and projected misstatements. The proposed standard describes three similar categories of misstatements like ISA 450 but does so in a general manner without applying defined terms.

Proposed Auditing Standard – Consideration of Materiality in Planning and Performing an Audit

The respective IAASB standard regarding consideration of materiality in planning and performing an audit is ISA 320, *Materiality in Planning and Performing an Audit*.

The introduction to ISA 320 discusses certain characteristics of materiality that the ISA indicates can provide a frame of reference if the concept of materiality is not discussed in the applicable financial reporting framework. Such a discussion is not needed in the Board's standards because the concept of materiality, as it applies under the federal securities laws, has been described by the U.S. Supreme Court.

ISA 320 contains a discussion of assumed characteristics of financial statement users. Such a discussion is not included in the proposed standard. Instead, the proposed standard refers to a "reasonable investor," which is consistent with the concept of materiality in the federal securities laws.

ISA 320 discusses, but does not require, the use of quantitative benchmarks in the determination of materiality for the financial statements as a whole. The proposed standard does not specifically discuss the use of quantitative benchmarks. Since the proposed standard neither requires nor prohibits the use of benchmarks, auditors may use them as long as the materiality level that they establish is appropriate and takes into account the surrounding circumstances, as discussed previously.

ISA 320 has a requirement similar to the proposed standard regarding the determination of tolerable misstatement, but the ISA uses the term "performance materiality." The proposed standard retains the term "tolerable misstatement," which is the term used in existing PCAOB standards.[2/]

Proposed Auditing Standard – Audit Evidence

The respective IAASB standard is ISA 500, *Audit Evidence.* The proposed standard is similar in many respects to ISA 500. The following are the primary differences between the proposed standard and ISA 500:

- The objective was revised to use the formulation of obtaining sufficient appropriate audit evidence "to support the opinion," which is more consistent with the requirements in the proposed standard on evaluating audit results and Auditing Standard No. 5.

- The standard describes financial statement assertions using the five categories of assertions in Auditing Standard No. 5 and AU sec. 326 instead of the 13 categories in ISA 500. However, the proposed standard would not preclude auditors from using the 13 categories in the ISAs.

ISA 500 includes direction regarding using the work of "management's expert." Establishing requirements and providing direction regarding using the work of a specialist is the subject of another standards project, so the proposed standard does not include additional direction on that subject. However, certain paragraphs of the

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2/ AU sec. 350, *Audit Sampling.*

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proposed standard mention using the work of a specialist as audit evidence and refer the reader to AU sec. 336 for the relevant requirements.

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Exhibit 2(a)(B)
Alphabetical List of Comments
American Accounting Association, Auditing Standards Committee
BDO Seidman, LLP
California Society of Certified Public Accountants, Mark F. Wille, Chair, Accounting Principles and Auditing Standards Committee
CalPERS, Mary Hartman Morris, Investment Officer
Center for Audit Quality, Cynthia M. Fornelli, Executive Director
Crowe Horwath LLP
Deloitte & Touche LLP
Ernst & Young LLP
Federation of European Accountants, Hans van Damme, President
Financial Executives International, Arnold C. Hanish, Chairman, Committee on Corporate Reporting
Grant Thornton LLP
Illinois CPA Society, Audit and Assurance Services Committee, Jon R. Hoffmeister
Institut der Wirtschaftsprüfer in Deutschland e.V., Klaus-Peter Feld, Executive Director
International Auditing and Assurance Standards Board, James M. Sylph, Executive Director, Professional Standards
ISG Metrics LLC, Beckwith B. Miller, CEO
Professor William Kinney, The University of Texas at Austin, McCombs School of Business

KPMG LLP
Dr. Joseph S. Maresca
Mayer Hoffman McCann P.C
McGladrey & Pullen LLP
Moss Adams LLP
New York State Society of Certified Public Accountants, Sharon Sabba Fierstein, President
New York State Society of Certified Public Accountants, Sharon Sabba Fierstein, President
PricewaterhouseCoopers LLP
R.G. Scott & Associates, LLC; Rod Scott
Roger Rotolante
August Saibeni, Adjunct Instructor, Cosumnes River College
The Institute of Chartered Accountants in England and Wales, Katharine E Bagshaw, Manager, Auditing Standards
The Institute of Internal Auditors, Richard Chambers
Jerry L. Turner, Professor of Accountancy, School of Accountancy, The University of Memphis
U.S. Chamber of Commerce, Richard Murray, Chairman, Center for Capital Markets Competitiveness
U.S. Government Accountability Office, Jeanette M. Franzel, Managing Director, Financial Management & Assurance
Graham Ward

February 18, 2009

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Via email to comments@pcaobus.org

RE: PCAOB Rulemaking Docket Matter No. 026: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards.

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on the *PCAOB Rulemaking Docket Matter No. 026: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards*. We very much appreciate the opportunity to provide input.

The views expressed in this letter and attachments are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist in finalizing the proposed guidance. If the Board has any questions about our input, please feel free to contact our committee chair for additional follow-up.

Respectfully submitted,

Auditing Standards Committee
Auditing Section - American Accounting Association

Committee Members:
Chair – Randal J. Elder, Syracuse University, tel: 315-443-3359, email: rjelder@syr.edu
Past Chair – Thomas M. Kozloski, Wilfred Laurier University
Vice Chair – James Bierstaker, Villanova University
Larry Abbott, University of Memphis
Steven Firer, Monash University – South Africa
Ed O'Donnell, University of Kansas
Susan Parker, Santa Clara University
Sandra Shelton, DePaul University

General Comments

The Committee commends the PCAOB ("the Board") for generally maintaining consistency with International Standards on Auditing (ISAs) in developing these risk assessment standards. We believe that convergence with international standards is desirable. It would be preferable to have one set of primary standards based on ISAs, with PCAOB auditing standards for requirements unique to U.S. registered securities. Until this level of convergence is possible, the approach taken in these standards appears to be the best option. The Committee also believes that the focus on the iterative nature of the audit and the continued recognition of differences in approach that depend on the size and complexity of the client and the engagement are positive features of these standards. In addition, given the scope and focus of the proposed standards, we believe that these standards do indeed provide an improved foundation for future standard setting, as the Board intended.

The Committee believes the proposed standards do appropriately address the risk of fraud. Important concerns and requirements about fraud are integrated into the proposed standards and overall theme of assessing the risk of material misstatement, whether due to error or fraud. The Board indicates that practice inspections revealed a tendency for auditors to view the consideration of the risk of fraud as something separate from the rest of the audit. However, in integrating fraud risk assessments into the overall risk assessment process, it is important to retain the emphasis in the interim standards that the auditor appropriately identify and respond to the risk of fraud. In appropriately integrating fraud guidance into the proposed risk assessment standards, the Board has chosen to re-emphasize certain aspects of interim standard AU 316, such as the engagement team meeting to discuss fraud, and the requirement to consider fraud risk for revenue recognition. However, this approach may detract from the overall clarity of the standards and be confusing to those in practice. The Board should consider fully integrating fraud assessment with the new risk assessment standards by bringing forward all concepts they consider relevant from interim standard AU 316.

The following section presents a number of specific comments or suggestions relating to the proposed standards, organized along the lines of the questions posed by the Board in Appendix 9 of the proposed standards.

<u>Comments Addressing PCAOB-proposed Questions</u>

Proposed Auditing Standard, *Audit Risk in an Audit of Financial Statements*

1. Does the proposed standard appropriately describe audit risk and its component risks?

The proposed standard maintains familiar terminology that appropriately describes audit risk. However, we believe that this description could be enhanced in several regards.

Paragraph six of the proposed standard refers to risk of material misstatement at the overall financial statement level. We believe that this is confusing since inherent risk as described in paragraph 7a is at the assertion level. We prefer that the financial statement level risks be referred to as pervasive risks that may affect many accounts and assertions, and account-specific risks be defined as those that may affect one or more specific assertions in an account or class of transactions.

It may be appropriate to reference the proposed standard on *Identifying and Assessing Risks of Material Misstatement* to note that these risks are identified by performing risk assessment procedures, including identifying client business risks and other factors that may give rise to these risks.

Research suggests that auditors respond more to risks that increase income and assets (Abbott et al. 2004; Houston et al. 1999). It may be helpful to note in paragraph five that material misstatements can arise from both understatements and overstatements of assets and income.

Proposed Auditing Standard, *Audit Planning and Supervision*

3. Is the direction regarding multi-location engagements reasonable and appropriate?

4. Is more direction needed regarding multi-location engagements? If so, in what areas is additional direction needed?

In general, the Committee believes the direction regarding multi-location audits is appropriate. We believe additional guidance could be helpful in addressing materiality for multi-location audits, as well as unpredictability of audit procedures. In paragraph 11b, when evaluating the materiality of the location or business unit, it is critical that the auditor consider the materiality of all units not tested in the aggregate. We note that the interim standard on fraud required the auditor to incorporate unpredictability in testing, including “performing procedures at different locations or at locations on an unannounced basis.” Unpredictability is addressed in paragraph 4c of *The Auditor’s Response to the Risks of Material Misstatement*, but does not include this terminology related to other multi-location engagements. It is important that client management and personnel are not led to believe that any locations or units will be exempt from testing.

Although not directly related to any of the questions posed in Appendix 9, we believe that the discussion in paragraph 13 should be expanded to discuss the role of other types of specialists and how they might be used in the audit, consistent with the discussion on Page A9-3.

Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*

7. Are the additional procedures in paragraph 13 that the auditor should consider performing when obtaining an understanding of the company and its environment reasonable and appropriate for audits of issuers? Should these procedures be specifically required for all audits, or is the responsibility to consider performing the procedures sufficient?

The Committee believes the procedures are appropriate. The Committee also believes the responsibility to consider performing the procedures is sufficient, although some Committee members expressed the belief that they should be specifically required.

8. Is the new requirement to assess certain matters related to the control environment component of internal control over financial reporting reasonable and appropriate? Is the difference between the required performance for an audit of internal control over financial reporting and an audit of financial statements only clear?

The committee believes the requirement is reasonable and appropriate. However, we do not find the distinction between the required performance for an audit of internal control over financial reporting and an audit of financial statements only to be clear. The requirements of the proposed standards are directed at audits of financial statements. Frequent notes that procedures may be performed in conjunction with the audit of internal control seem unnecessary – a single note would suffice. The note on Page A1-2 establishes that consideration of risk in an audit of internal control over financial reporting is addressed in Auditing Standard No. 5.

11. Does the additional description of key engagement team members provide a better understanding of the expected participants in the discussion?

We believe that the concept of key engagement team members may require further clarification, as the term "significant engagement responsibilities" is undefined. Further, the proposed standard does not address the role of IT or other specialists in these discussions. It can be implied that audit staff are not included in the key engagement team members. However, if these staff will be responsible for auditing areas with identified fraud risks, it would seem helpful to include them in the discussion. The distinction in paragraph 49 of items that should be emphasized to all engagement team members is helpful.

The tone set and participation by the engagement partner is critical to the success of the fraud risk assessment process (Carpenter and Reimers 2009). The "tone at the top" is an element of quality control that should be emphasized here. In addition, 'priming' the audit team discussion through the inclusion of recurring fraud risk factors appears to help in the assessment of fraud risk (Bamber et al. 2008). Although the use of checklists and decision aids may seem contrary to the idea of brainstorming, their use may ensure the completeness of the consideration of fraud risk factors.

12. Does the discussion of significant risks in this standard provide sufficient direction to enable auditors to identify significant risks?

We believe the term "significant risk" could be more clearly defined. We agree with the presumption of fraud risk for revenue recognition required in paragraph 61. However, we believe that fraud risk assessments should be linked back to output from the fraud risk brainstorming session. That is, we would clarify how the auditor should document that the presumption of a revenue recognition fraud risk is overcome, and also consider what areas may constitute a greater area of fraud risk given the nature of the entity's business.

13. Should the proposed standards include specific requirements and direction regarding documentation, e.g., summaries of the identified and assessed risks and the linkage to the auditor's responses?

We appreciate the desire to not prescribe additional documentation requirements beyond those contained in Auditing Standard No. 3. However, because of the importance of identifying significant risks and the auditor's response to those risks, as well as the repeated findings of observers such as the Panel on Audit Effectiveness ("the PAE") (POB 2000) and academic researchers (e.g., Zimbelman 1997) that have noted the failure of auditors to identify significant risks and link those risks they did identify to specific audit responses, we believe the proposed standards should include a documentation requirement that the auditor summarize all significant risks, the auditor's response to those risks, and the findings of the procedures.

In the introduction to the proposed standards, the Board notes that the PAE report (POB 2000) indicated that many audits were performed using substantive testing approaches with little or no attention paid to risk assessments. The Board should consider additional guidance to discourage or explicitly discourage a default to maximum risk assessment.

In our comments on question 14, we specifically address the need for additional guidance on the assessment of control risk and performance of tests of controls. The risk of material misstatement is the combination of inherent risk and control risk. Assessment of control risk below maximum generally requires the performance of tests of controls. However, there is no similar requirement for inherent risk. Are the risk assessment procedures suggested in the proposed standards sufficient to support a low assessed level of inherent risk if no specific risks of misstatement are identified? What documentation of the risk assessment procedures is necessary to support a low assessed level of inherent risk at the assertion level?

Additional Comments Related to the Proposed Standard

Special Audit Consideration – We believe that the concept "special audit consideration" in response to the term "significant risk" in paragraph 4b needs further clarification. Does this imply changes in audit procedures or the overall conduct of the audit? We note that all fraud risks are significant risks, and may warrant special consideration, but the response could be in the form of additional testing, rather than changes in procedures or the overall conduct of the audit.

Control Activities – We also note that the proposed standard does not provide any detailed discussion of control activities in paragraph 34. Given their importance to the risk assessment process and the assessment of control risk, some additional discussion of the nature of control activities seems appropriate.

Considering Information from Review Engagements – Paragraph 40 directs the auditor to evaluate whether information obtained from reviews of interim financial information is relevant to identifying risks of material misstatement in the year-end audit. The Board should provide additional guidance in this area as research has indicated that fraudulent financial reporting at year-end often begins in an interim period (Beasley et al. 1999).

Non-Financial Performance Measures – In "Performing Analytical Procedures" (par. 42-44), the proposed standard should encourage the use of non-financial performance measures since they may be indicators of fraud and may be less vulnerable to manipulation or concealment than financial statement amounts (Brazel et al. 2008).

Presumption of Management Honesty and Integrity – The tone of the wording in paragraph 48 seems to imply that the auditor should adopt a mindset that assumes that management lacks integrity and is dishonest. Instead the language should direct that the auditor maintain an attitude of professional skepticism that assumes neither integrity nor lack of integrity, honesty nor dishonesty.

Timing of Significant Transactions – Paragraph 63f discusses significant transactions that "appear to be unusual due to their size or nature." This phrase might also include the concept of "timing", as the timing of significant transactions (near year-end, for example) could be an indicator of risk.

Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*

14. Does the proposed standard clearly describe the auditor's responsibilities regarding tests of controls in integrated audits and in audits of financial statements only?

We believe the proposed standard does clearly describe the auditor's responsibilities. However, we note that there has been some confusion about the need to perform tests of controls in an audit of the financial statements only. We read the standard to indicate that tests of controls are not required if control risk is assessed at maximum and sufficient appropriate evidence can be obtained from substantive procedures alone. This is the case even if evaluation of the design and implementation of controls indicates that controls are effective. Also, we believe clear guidance needs to be provided as to the reliance, if any, that can be placed on controls based on risk assessment procedures related to the design and implementation of controls.

We also note that in paragraph 50, the word "detects" in the second line should be moved to the first line immediately before "misstatements."

Proposed Auditing Standard, *Evaluating Audit Results*

18. Are the requirements and direction regarding accumulating identified misstatements and evaluating uncorrected misstatements appropriate and adequate?

Paragraph 19 indicates that the auditor should evaluate the effects of uncorrected misstatements detected in prior years on the accounts and disclosures, and the financial statements as a whole, but does not prescribe how they should be considered. In the past, firms have either followed the so-called "iron curtain" approach in which all cumulative uncorrected misstatements are deemed to affect the current period income statement, while others followed the "rollover" approach which quantifies a misstatement based on the amount of the misstatement originating in the current year and ignores the effects of prior year misstatements (POB 2000). Staff Accounting Bulletin 108 (SEC 2006) requires registrants to use a dual approach in considering the potential effects of uncorrected misstatements. It may be helpful to add a footnote describing these two approaches.

Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*

The Committee believes the requirements are aligned with the concept of materiality as described in the courts' interpretation of the federal securities laws. We believe the standard could expand on the discussion of qualitative aspects of materiality, although the PCAOB may prefer to rely on SEC Staff Accounting Bulletin 99 and other sources for guidance in this regard.

22. *Is the use of the term "tolerable misstatement" in the proposed standard appropriate and sufficiently clear?*

We believe the term tolerable misstatement is appropriate and clear with regard to AU sec. 350, but the proposed standard would be clearer if tolerable misstatement was redefined in the standard. We believe there is the possibility of confusion about materiality for specific accounts and tolerable misstatement, and a footnote or clarifying language could help distinguish these two concepts.

Proposed Auditing Standard, *Audit Evidence*

The Committee believes the principles for evaluating the sufficiency, relevance, and reliability of evidence are clear and we agree with the alignment in terminology with the ISAs. The guidance on authentication should help auditors evaluate and respond to the possibility that documents may not be authentic.

26. *Are the five categories of assertions in this standard sufficient or should they be expanded? If so, how would such expansion affect auditor performance?*

The retention of the five categories of assertions in AU sec. 326 is one case where the proposed standards differ significantly from the 13 assertions in the ISAs. The proposed standard allows for the use of other assertions, but the inconsistency adds complexity and confusion about the assertions. We do not necessarily believe that the 13 assertions in the ISAs are the most appropriate. However, we believe the proposed standard could improve and expand on the five assertions in AU sec. 326 and provide greater consistency with the ISA assertions.

The assertions for existence or occurrence and completeness already indicate that they apply to transactions and accounts. Providing for a core set of assertions and noting that they apply to three categories – classes of transactions, account balances, and presentation and disclosure – would more closely align the assertions with the ISA assertions. This would also highlight the differences in these assertions when applied to classes of transactions, account balances, and presentation and disclosure. Such an approach would provide greater emphasis on presentation and disclosure.

We believe that additional assertions for net realizable and/or fair value as well as cutoff should be considered. Net realizable value and fair value are encompassed in the valuation or allocation assertion. However, the auditing importance of these issues might merit a separate assertion, and we note that several large CPA firms do apply separate assertions or audit objectives for the accuracy and realizable value components of valuation.

Our suggested assertion for cutoff goes beyond the concept of examining whether transactions at or near year-end are recorded in the proper period and would encompass the period-end financial reporting process as discussed in paragraph 32 on page A3–13–Standard.

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BDO Seidman, LLP
Accountants and Consultants

100 Park Avenue
New York, New York 10017
Telephone: 212-885-8000
Fax: 212-697-1299

February 18, 2009
Via E-mail: comments@pcaobus.org

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Release No. 2008-006, Rule Making Docket Matter No. 026, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk,* and *Conforming Amendments to PCAOB Standards*

Dear Members and Staff of the Public Company Accounting Oversight Board:

BDO Seidman, LLP welcomes this opportunity to comment on the PCAOB's *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (the proposed standards). Overall, we support these proposed standards that collectively update the PCAOB's interim standards to reflect the importance of the identification and assessment of risks and the resultant response to such assessed risks. While many firms have incorporated the enhanced risk assessment procedures into their methodologies as a result of the guidance provided within the AICPA's and the International Auditing and Assurance Standards Board's (IAASB) audit risk standards, we believe it is important for the PCAOB to also incorporate these risk assessment principles into their extant interim standards to promote consistently high auditor performance. We provide the following overall general comments, followed by our responses to the specific questions posed in the release.

Convergence with IAASB International Auditing Standards

As set out in the release, we support the convergence efforts already undertaken by the Board, including participation at various levels in the international standard setting process, and the inclusion of an appendix within the proposed standards that outlines the significant differences between the International Auditing Standards (ISAs) and the proposed standards to help auditors understand what is expected of them under each set of standards. The development of high quality standards that converge with the ISAs, where appropriate to do so, will promote the performance of high quality audits, especially for those audits performed on multinational entities. Additionally, convergence will have a positive impact on costs related to the development of a single audit methodology, and to updating training programs, audit manuals, and other firm guidance. These matters are particularly significant for firms that operate as part of an international network.

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While we recognize the very important steps taken to date, we strongly encourage the Board to more fully engage in the standard setting process with both the IAASB and the AICPA, to ensure that the auditing standards are consistent to the fullest extent possible and only differ when necessary due to the nature of the audit of a public company. We believe each standard setter should use the ISAs as a starting point, and diverge from that guidance only when necessitated by any unique circumstances or laws and regulations related to auditing and reporting within their jurisdiction. In the circumstances where substantive differences are proposed, we support the identification and presentation of such differences (at a paragraph level) in an exhibit to assist practitioners in evaluating the impact of these differences on their audit methodology. In following such an approach, we suggest that all standards include an objective that is action-based, such that the required procedures support the achievement of the objective. Since not all circumstances can be anticipated in a standard, the objective provides a reference point against which the auditor would assess whether in his or her professional judgment the objective of the standard had been met or whether additional procedures needed to be performed.

We noted that in some instances, application guidance from the ISA had been elevated to a requirement in the proposed standards. For example, in the proposed standard, Appendix 3, *Identifying and Assessing Risks of Material Misstatement*, paragraph 52(d) describes the procedures the auditor should perform in all circumstances related to specific inquires about fraud with accounting and financial reporting personnel, whereas the ISA (ISA 240 paragraph A16) provides guidance that permits the auditor to use professional judgment in determining to whom in the entity it is most appropriate to address fraud inquiries. In instances such as this, where guidance has been elevated to a requirement or where requirements are not carried forward from the ISA guidance to the proposed standard, we believe that the underlying rationale should be provided in an appendix.

One Risk Assessment Process

The top-down risk-based approach, as provided for in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements (AS 5)*, is an essential element in assessing the risk of material misstatement, not only for an integrated audit but also for a financial statement only audit. The same risk assessment process is followed in both instances, whereby the auditor obtains an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement starting at the entity level. Accordingly, we encourage the PCAOB to integrate this guidance into the risk assessment standards to facilitate this approach to risk assessment.

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Additionally, we suggest that the guidance included within AS 5, paragraphs 34 through 39, about the auditor's understanding of the significant processes, identification of points within the process where a risk of material misstatement exists, and identification and assessment of the design of controls within those processes to address those risks, be included within the proposed standards, and deleted from AS 5. These procedures relate to a risk assessment process that should be performed regardless of whether the engagement is an integrated audit or a financial statement only audit.

Moreover, we noted that much of the guidance related to the risk assessment with respect to an integrated audit as set out in the proposed standard would be included in both AS 5 and the PCAOB's suite of risk assessment standards. Since the risk assessment process should be the same regardless of whether the audit is integrated or financial statement only, we believe that the risk assessment guidance only needs to be included within these risk assessment standards and that AS 5 should only include those additional procedures necessary to complete the audit of internal control over financial reporting.

Integration of Fraud Guidance

We support the integration of the fraud guidance from the interim standards into the proposed standards, as we believe it emphasizes that the fraud procedures are not "add-on" procedures but rather an essential element to the risk assessment process. However, we noted that certain paragraphs from the PCAOB interim standard, AU sec. 316, were deleted and not included within the proposed risk standards, specifically (1) PCAOB interim standard AU sec. 316.77, item c, which deals with the discussion of misstatements with management at least one level above those involved that may be material to the financial statements and that are or may be the result of fraud and (2) item d of that paragraph, which provides that, if appropriate, the auditor should suggest that the client consult with legal counsel. We believe that this guidance should not be deleted and also recommend that a full review of the deleted fraud guidance, as set out in Appendix 8, be performed to ensure that no other relevant paragraphs have been unintentionally deleted.

Scalability

We support the efforts made to introduce the concept of scalability into the proposed standards and encourage the PCAOB to enhance that guidance. The recent issuance of the publication, *Staff Views – An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit Of Financial Statements: Guidance for Auditors of Smaller Public Companies*, illustrates various opportunities to scale the audit throughout the risk assessment process. We recommend that the appropriate guidance from this publication be incorporated in the proposed standard, similar to the way the fraud guidance has been interwoven, to provide an "integrated" approach to the risk assessment process.

Effective Date

While no effective date was proposed in the release, we encourage the PCAOB to ensure that sufficient time is provided for firms to incorporate the proposed standards into their audit methodology and training programs so that implementation supports the goal of high quality audits.

Responses to Questions Posed in the Release

Audit Risk in an Audit of Financial Statements

1. **Does the proposed standard appropriately describe audit risk and its component risks?**

   Overall, we agree with the description of audit risk and its component risks within the proposed standard; however, we suggest including the following phrase at the end of the first sentence in paragraph 3, "and whether any material weaknesses exist as of the date of management's assessment" to recognize that audit risk in an integrated audit must also include this separate but related consideration.

   Additionally, we believe that the guidance provided with respect to the risk of material misstatement at the financial misstatement level, included in paragraph 6, should be expanded to include guidance similar to that included in ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment* (ISA 315), paragraphs A98 – A101. This guidance provides a description of the types of risk that are considered to be financial statement level risks and emphasizes that financial statement level risk may be especially relevant when considering the risks of material misstatement arising from fraud.

Audit Planning and Supervision

2. **Is it reasonable and appropriate to extend the Auditing Standard No. 5 requirement regarding consideration of matters important to the audit of internal control over financial reporting to audits of financial statements?**

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We agree that it is reasonable and appropriate to include the matters listed in AS 5 paragraph 6 within paragraph 7 of Appendix 2 of the proposed standard, since these factors are relevant to both an audit of internal control over financial reporting and to a financial statement only audit. As noted above, we believe the planning and risk assessment process should be the same for both audits.

3. **Is the direction regarding multi-location engagements reasonable and appropriate?**

While the overall direction regarding multi-location engagements is reasonable and appropriate, we suggest that guidance regarding multi-location scoping decisions from AS 5 (e.g., paragraphs B10 through B16) be moved to the proposed standard, since the same scoping decisions would apply to either an integrated audit or an audit of financial statements.

Additionally, we believe that all risk assessment guidance should be included within one standard, and as such, suggest removing that guidance from AS 5 and including it within this proposed standard to support the concept that there is only one risk assessment process.

4. **Is more direction needed regarding multi-location engagements? If so, in what areas is additional direction needed?**

In addition to our response above, we also believe that it may be helpful to provide additional direction on the unique issues surrounding multi-location engagements that apply within a group audit situation, and as such recommend including within this standard the applicable guidance from ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors),* specifically guidance relating to determining the type of work to be performed on the financial information of components, both significant and not significant.

5. **Are the responsibilities of the engagement partner for planning and supervision appropriate and reasonable, and is the proposed direction clear?**

We have the following suggestions to improve the clarity of the responsibilities of the engagement partner for planning and supervision. First, we recommend the PCAOB move paragraph 3 of the proposed standard from the "Objective of the Auditor" section of the proposed standard and incorporate it as a requirement under the "Planning an Audit" and "Supervision" sections of the standard. We believe that the objective of each individual standard should focus the auditor on

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the desired outcome of the standard, while being specific enough so that the auditor (1) understands what needs to be accomplished and how, and (2) can decide whether the objective has been met or whether additional audit procedures need to be performed. The current structure of the objective, as stated in paragraph 3, is not an objective of the auditor, but rather a required procedure.

Additionally, we believe that the proposed standard would benefit from the inclusion of paragraphs A5 and A9 of ISA 300, *Planning an Audit of Financial Statements*, which provides a further description of the role of the engagement partner and other key members of the engagement team.

Further, the first sentence of paragraph 21 states that the partner and team members "should make themselves aware" of certain procedures to be followed when there are differences of opinion among the team. This phrase is unclear, and as such we recommend the PCAOB provide specific guidance about the steps to be taken in this circumstance either within this proposed standard and/or within the quality control standards.

<u>Identifying and Assessing Risks of Material Misstatement</u>

6. Does the proposed standard clearly and adequately describe the auditor's responsibilities for performing risk assessment procedures?

We believe that the proposed standard could better describe the auditor's responsibilities for performing risk assessment procedures and provide the following suggestions for improvement. As noted earlier, we support convergence with the ISAs and the development of objectives that focus on desired outcomes. Accordingly, we suggest revising the objective of this proposed standard to conform to ISA 315 which states:

> "The objective of the auditor is to identify and assess the risks of material misstatement whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement."

Additionally, the definition in paragraph 4 of significant risk differs from the definition in ISA 315 in that it does not refer to "identified and assessed" risks or "auditor's judgment." We believe each of these concepts is integral to the concept of significant risk, and as such, we recommend revising the proposed

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definition as follows (with additions to the proposed standard shown in italics and deleted text as strikethrough text), to emphasize the direct link between assessment of risk and planned procedures, based on the auditor's judgment:

> "Significant risk – *An identified and assessed* risk of material misstatement that ~~is important enough to~~ *in the auditor's judgment* ~~to~~ requires special audit consideration."

Further, in some instances we noted that application guidance from ISA 315 was elevated to a presumptive requirement in the proposed standard; for example, paragraph 6 of the proposed standard states the auditor's risk assessment procedures *should* include certain matters, whereas the related guidance in ISA 315, paragraph 6 includes this as application guidance. We recognize that some of the differences between the ISA guidance and the proposed standards are provided in Appendix 10; however, it is not complete, and at times the judgments supporting the conclusions are not apparent. As such, we suggest providing a more robust description of differences between the ISAs and the proposed standards to enhance the auditor's understanding of the reasons for the differences and whether the intention is to change auditor behavior from what it would be under the ISAs.

7. **Are the additional procedures in paragraph 13 that the auditor should consider performing when obtaining an understanding of the company and its environment reasonable and appropriate for audits of issuers? Should these procedures be specifically required for all audits, or is the responsibility to consider performing the procedures sufficient?**

We agree that the additional procedures in paragraph 13 seem reasonable and appropriate for the auditor to consider when obtaining an understanding of the company and its environment for audits of issuers. Additionally, we believe that these procedures should not be a requirement, but rather should provide guidance about the types of procedures that may be performed to satisfy the presumptive requirement included in paragraph 9, which states the "auditor's understanding of the company <u>should</u> include …the nature of the company…"

In addition, we are uncertain about the meaning of the term "should consider" specifically with respect to the expected auditor action and related documentation to support such consideration. Accordingly, we suggest replacing the phrase "should consider" with the phrase "may consider." Since this guidance supports the requirement to understand the nature of the company, we believe that this structure would provide appropriate guidance.

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8. **Is the new requirement to assess certain matters related to the control environment component of internal control over financial reporting reasonable and appropriate? Is the difference between the required performance for an audit of internal control over financial reporting and an audit of financial statements only clear?**

   Overall, we agree that the new requirement, included in paragraph 26 of Appendix 3, to assess (1) whether management's philosophy and operating style promotes effective internal control over financial reporting, (2) whether sound integrity and ethical values, particularly of top management, are developed and understood, and (3) whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control, is reasonable and appropriate. As described in Appendix 9 of the release, this new requirement is aligned with the requirements in AS 5, specifically paragraph 20; however, we noted that one of the factors from paragraph 20 of AS 5, relating to whether the company takes actions to reduce or mitigate the incentives and pressures on management that would provide a reason to misstate the company's financial statements, was not included within the proposed standard, even though it seems applicable to both an integrated audit and a financial statement only audit. We believe that the proposed standard would be strengthened by the inclusion of this consideration, which furthers the PCAOB's goal of integrating the auditor's consideration of fraud risk factors within the risk assessment process.

   While we support aligning the risk assessment process from AS 5 with these proposed standards, we recognize that the amount of audit attention devoted to understanding whether controls are appropriately designed and implemented will differ depending on various factors, including whether the audit strategy contemplates more testing of controls (e.g., in an integrated audit), the company's internal control is more complex, or the company's controls have changed significantly. This concept is clearly presented in Appendix 9; however, the proposed standard does not include such a discussion, which we believe would clarify how this requirement is intended to be implemented in differing circumstances. For this reason, we recommend including this "application" guidance as part of the proposed standard.

9. **Is the additional direction regarding the period-end reporting process reasonable and appropriate for audits of financial statements only?**

   We support including the additional direction regarding the period-end reporting process for audits of financial statements only that is included in paragraph 32 of this proposed standard. This guidance aligns with both AS 5 and ISA 315 (paragraph A77) and, in addition to strengthening the PCAOB's interim standards, would also promote convergence with the ISAs, which we support.

   The note to paragraph 32 states that in an integrated audit, the auditor's procedures for obtaining an understanding of the company's monitoring activities might be performed in conjunction with the evaluation of entity-level controls. We believe that auditors in each type of engagement would obtain this understanding as part of their top-down approach to assessing risk, whereby the auditor obtains an understanding of the entity level controls first to understand the top level controls that may mitigate the risk of material misstatement before assessing the lower level controls. For this reason, we suggest revising the note to recognize the applicability of the top-down approach to both an integrated and financial statement only audit.

10. **Are the requirements and direction regarding the auditor's responsibilities for evaluating design and implementation of controls as part of obtaining an understanding of internal control over financial reporting sufficient and clear? If not, what additional direction is needed?**

    Overall, the requirements and direction seem appropriate; however, we believe this guidance could be strengthened through the addition of guidance that describes the benefits of a walkthrough in assessing the design and implementation of controls, similar to that included in paragraph 37 of AS 5. Additionally, the guidance in paragraph 39 of AS 5, relating to the use of probing questions in gaining a sufficient understanding of the process, is an essential procedure in gaining the necessary understanding of internal control over financial reporting as part of a robust risk assessment, and as such should be incorporated in the proposed standard.

11. **Does the additional description of the key engagement team members provide a better understanding of the expected participants in the discussion?**

    We agree that the key engagement members should participate in the discussion regarding the risks of material misstatement as part of the risk assessment

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process, and that the key engagement team members include the engagement partner and all engagement team members who have significant engagement responsibilities.

12. Does the discussion of significant risks in this standard provide sufficient direction to enable auditors to identify significant risks?

The discussion of significant risks as set out in paragraph 63 of the proposed standard is consistent with that in ISA 315 and we believe provide sufficient direction. However, see our response to question 6 above regarding changes we believe are necessary to the definition of significant risk.

13. Should the proposed standards include specific requirements and direction regarding documentation, e.g., summaries of the identified and assessed risks and the linkage to the auditor's responses?

No additional documentation direction is necessary beyond that already included within Auditing Standard No. 3.

<u>The Auditor's Responses to the Risks of Material Misstatement</u>

14. Does the proposed standard clearly describe the auditor's responsibilities regarding tests of controls in integrated audits and in audits of financial statements only?

We believe that the proposed standards should only include guidance related to testing controls in a financial statement only audit, with the incremental testing necessary to meet the objective of tests of controls in an integrated audit maintained in AS 5. In this way, the proposed standards would not unnecessarily repeat guidance contained elsewhere (AS 5) and more clearly set out the requirements for testing controls in the financial statement only audit. We agree with the PCAOB's view, as set out in Appendix 9 of the release, that the basic principles for designing and performing tests of controls are the same for the audit of internal control over financial reporting and the audit of the financial statements. Accordingly, we believe that this guidance in the proposed standard is appropriate. However, we believe it would clarify the incremental procedures necessary to support the auditor's opinion on internal control over financial reporting if this incremental guidance were included solely in AS 5.

Additionally, we believe footnote 14 to paragraph 18, which provides guidance about the "period of reliance" with respect to testing controls in a financial statement audit, should be included within the body of the standard. Further, including implementation guidance similar to ISA 330, *The Auditor's Responses to Assessed Risks* (ISA 330), paragraph A32, which provides an example of how evidence pertaining only to a point in time may be sufficient for the auditor's purpose and explains that controls over the entity's physical inventory counting at the period end may be an example of such a control, would help clarify the concept.

15. Are the requirements and direction regarding tests of controls appropriately aligned with Auditing Standard No. 5?

See our response to Question 14 above.

16. Does the proposed standard clearly describe the auditor's responsibilities regarding substantive procedures?

Overall, we support the emphasis in the proposed standard, which provides direction that is intended to lead auditors to design audit procedures that are based on and address the risks of material misstatement. However, we note that the guidance in Appendix 4, paragraph 45, which requires the auditor to perform substantive procedures, *including tests of details* [emphasis added], to respond to significant risks, does not appropriately consider that in certain circumstances it may not be possible to perform such tests of details (e.g., when a client transacts substantial business through EDI) or that the most effective way to address the risk may be accomplished through a combination of tests of controls and substantive procedures. These considerations are consistent with ISA 330, paragraph 22, which states:

> "When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of detail."

<u>**Evaluating Audit Results**</u>

17. Does the proposed standard clearly describe the auditor's responsibilities regarding the evaluation of audit results?

We support the PCAOB's approach to consolidate into one standard the requirements and direction regarding the auditor's responsibilities regarding the evaluation of audit results. However, the objective as stated does not provide the appropriate context with which to evaluate whether the procedures performed achieve the desired outcome. In ISA 450, *Evaluation of Misstatements Identified During the Audit* (ISA 450), for example, the objective of the auditor is to evaluate (a) the effect of the identified misstatements on the audit, and (b) the effect of uncorrected misstatements, if any, on the financial statements. This objective provides a benchmark against which auditor performance can be gauged with respect to evaluating identified misstatements. We suggest using the ISA objective as a starting point in developing a broader objective that would encompass the range of topics included within the standard as set out in paragraph 5 of Appendix 5.

18. Are the requirements and direction regarding the accumulating identified misstatements and evaluating uncorrected misstatements appropriate and adequate?

To improve the direction in this area, we suggest enhancing the guidance in paragraph 13 of Appendix 5 by further clarifying that "clearly trivial" is not another expression for "not material" as set out more fully in ISA 450, paragraph A2. Although this term is generally understood to mean matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstance, we believe the clarity of the proposed standard would be enhanced by including this definition.

Another area where we believe the direction regarding misstatements can be improved is with respect to the use of the term "identified misstatements." Although we understand this term to represent known or factual misstatements, this term is not defined and may also be understood to include projected misstatements and misstatements related to accounting estimates that are outside of a reasonable range. ISA 450, paragraph A3 distinguishes between factual misstatements, judgmental misstatements, and projected misstatements, and defines each. We believe that since the intent of the PCAOB's standards is the same as that set out in the ISA, the PCAOB should use the terms set out in ISA 450, which we believe improves clarity and provides for the use of consistent terminology in auditing guidance of different standard setters when no difference in meaning is intended.

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19. Are the requirements and direction regarding the evaluation of the results of the integrated audit appropriately aligned with Auditing Standard No. 5?

As we stated in the front part of the letter, we agree that all guidance relating to the risk assessment process that is applicable to both a financial statement only audit and an integrated audit should be included within these proposed standards, with conforming amendments made to AS 5 to eliminate redundancy. Further, we suggest removing guidance that solely relates to AS 5 from these standards so that any guidance specific solely to an audit of internal control over financial reporting would be included in AS 5.

Consideration of Materiality in Planning and Performing an Audit

20. Are the requirements and direction in this standard appropriately aligned with the concept of materiality as described in the courts' interpretation of the federal securities laws?

The concept of materiality as set out in paragraph 2 of the proposed standard appears appropriately aligned with the courts' interpretation of the federal securities law, which recognizes that materiality is developed in reference to a "reasonable person" relying upon the report. However, we note that paragraph 7 of the proposed standard refers to a reasonable investor when considering whether certain accounts or disclosures may carry more weight with financial statement readers. The use of the term "reasonable investor" is not internally consistent nor is the term used in the ISAs, which uses the term "user of the financial statements." For these reasons, we suggest changing the term to "financial statement users."

21. Does the proposed standard sufficiently and clearly describe the auditor's responsibilities regarding (a) establishing an appropriate materiality level for the financial statements as a whole and (b) establishing a lower materiality level or levels for particular accounts or disclosures? If not, what additional direction is needed?

We believe the proposed standard appropriately describes the auditor's responsibilities.

22. Is the use of the term "tolerable misstatement" in the proposed standard appropriate and sufficiently clear?

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We believe that since the term "tolerable misstatement" has the same meaning as the term "performance materiality" in ISA 320, *Materiality in Planning and Performing an Audit*, the PCAOB should also use the term "performance materiality." Using the same terms when there is no difference in meaning will enhance auditor performance, especially in audits performed internationally. Additionally, this same term has been used by the AICPA Auditing Standards Board in the redrafting of its suite of audit risk standards, which has recently been issued for exposure.

Audit Evidence

23. Does the proposed standard clearly describe the principles necessary for evaluating the sufficiency, relevance, and reliability of audit evidence?

Overall, the proposed standard clearly describes the principles necessary for evaluating the sufficiency, relevance, and reliability of audit evidence; however, we believe the objective as stated is overly broad and should focus on how to design and perform audit procedures to obtain sufficient, appropriate audit evidence, similar to ISA 500, *Considering the Relevance and Reliability of Audit Evidence*, rather than on obtaining audit evidence sufficient to support the opinion.

24. Are the auditor's responsibilities regarding the authentication of documents reasonable and appropriate?

We believe that these responsibilities are reasonable and appropriate.

25. Are the requirements and direction related to selecting items for testing appropriate and clear?

We recommend adding guidance regarding the concept that the selective examination of specific items, particularly if those items are selected based on the auditor's belief that they are more likely to contain a misstatement, may provide the auditor with some audit evidence concerning the remainder of the population.

26. Are the five categories of assertions in this standard sufficient or should they be expanded? If so, how would such expansion affect auditor performance?

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While we recognize that the ISAs include 13 types of assertions within 3 broad categories that include transaction-based assertions, assertions about account balances at the period end, and assertions about presentation and disclosure, we do not believe that it is necessary to align directly to the ISA, since the proposed standard would not preclude auditors from using the 13 categories as set out in the ISAs.

***

We appreciate your consideration of our comments and suggestions, and would be pleased to discuss these with you at your convenience. Please direct any questions to Wayne Kolins, National Director of Assurance at 212-885-8595 (wkolins@bdo.com) or Susan Lister, National Director of Audit Policy at 212-885-8375 (slister@bdo.com).

Very truly yours,

/s/ BDO Seidman, LLP

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February 9, 2009

California Society Certified Public Accountants

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Response to PCAOB Rule-Making Docket Matter No. 026

To the Members of the PCAOB:

The Accounting Principles and Auditing Standards Committee (the AP&AS "Committee") of the California Society of Certified Public Accountants (CALCPA) is pleased to provide our comments to the Public Company Accounting Oversight Board (PCAOB) on PCAOB Rule-Making Docket Matter No. 026.

The AP&AS Committee is the senior technical committee of CALCPA. CALCPA has approximately 32,000 members. The Committee is comprised of 50 members, of whom 67 percent are from local or regional firms, 23 percent are sole practitioners in public practice, 5 percent are in industry and 5 percent are in academia.

The Committee has submitted its response in the following order: First, the Committee has provided its response on the PCAOB's comments set forth on pages 6-12 of the Release. Second, the Committee has provided its response to the questions in Appendix 9, as well as certain other observations for the PCAOB's consideration.

We thank you for the opportunity to comment on this matter. We would be glad to discuss our opinions further, should the PCAOB have any questions or require any additional information.

Very truly yours,

Mark F. Wille, Chair
Accounting Principles and Auditing Standards Committee
California Society of Certified Public Accountants

1235 Radio Road
Redwood City, CA
94065-1217

(800) 922-5272
www.calcpa.org

A. Response to the Board's Overall Request for Comments.

Comment 1: *The Board seeks comment on how the proposed standards would change current practice, whether the proposed standards allow sufficient flexibility and whether they are appropriately scalable.*

Response: The proposed standards will eliminate a void in current audit practice for non-integrated audits, which are currently being performed under the PCAOB's interim audit standards in effect when the PCAOB was formed. All audits ought to be risk-based. The proposed standards will not eliminate the need to exercise professional judgment. Accordingly, we believe the proposed standards are sufficiently flexible as well as scalable.

We support the PCAOB's goal of achieving a broad set of audit standards. To further this goal, we would encourage the PCAOB to consider codifying its proposed standards with existing standards for performing interim reviews and AS5 (integrated audits), in a manner similar to standards published by the American Institute of Certified Public Accountants.

Comment 2: *The Board seeks comment on whether these fundamental principles are articulated appropriately in the proposed standards.*

Response: We believe the fundamental principles are appropriately articulated in the proposed standards. To further strengthen the communication process in the transition to a fully integrated risk-based audit approach, we recommend the PCAOB publish the final standards with a supplemental marked up version of the affected original sections of the PCAOB interim audit standards.

We also believe communication would be enhanced if the PCAOB were to integrate the text of each proposed audit standard with the relevant supplemental text contained in Appendix 9.

Comment 3: *The Board seeks comment on whether these fundamental principles from Auditing Standard No. 5 have been incorporated appropriately in the proposed standards; whether the proposed standards are appropriately aligned with Auditing Standard No. 5, and, accordingly, whether the proposed standards would improve the effectiveness and efficiency of integrated audits.*

Response: We believe that AS5 was a much needed revision to AS2, which was difficult to apply in a cost effective manner. Therefore, AS5 appears to be appropriately aligned with the proposed standards.

Comment 4: *The Board seeks comment on whether the proposed standards focus appropriately on the risks of fraud.*

Response: We believe the proposed standards are responsive to the risks of fraud.

Comment 5: *The Board seeks comment on whether the proposed standards appropriately consider the provisions of the ISA's and whether they reflect necessary differences from risk assessment standards applicable outside the United States.*

Response: Until such time as international audit standards ("IAS") are adopted in the United States, it would be helpful if the PCAOB could publish its criteria for considering and/or integrating such standards with those of the PCAOB. We also encourage the PCAOB to avoid terminology that might be inconsistent with current IAS when drafting its standards. There appears to be an excessive amount of "word smithing" between the proposed standards as compared to IAS. Style differences ought to be avoided.

B. Responses to Questions in Appendix 9.

Proposed Auditing Standard – Audit Risk in an Audit of Financial Statements

Question 1: *Does the proposed standard appropriately describe audit risk and its component risks?*

Response: Yes. No specific comment.

Proposed Auditing Standard – Audit Planning and Supervision

Question 2: *Is it reasonable and appropriate to extend the auditing standard No. 5 requirement regarding consideration of matters important to the audit of internal control over financial reporting to audits of financial statements?*

Response: Yes. No specific comment.

Question 3: *Is the direction regarding multi-location engagements reasonable and appropriate?*

Response: Yes. No specific comment.

Question 4: *Is more direction needed regarding multi-location engagements? If so, in what areas is additional direction needed?*

Response: Sufficient guidance is provided in the proposed standard.

Question 5: *Are the responsibilities of the engagement partner for planning and supervision appropriate and reasonable and is the proposed direction clear?*

Response: The responsibilities are appropriate and reasonable in principle, but certain aspects could be clearer:

Paragraph 4, second sentence: The draft cites a planning process that "might begin shortly after (or in conjunction with) the completion of the previous audit." That "might" occur, but the auditor has no responsibility during the period from completion of one audit until engaged to perform the next. The sentence would be better stated: "Planning is not a discrete phase of an audit, but rather a continual and iterative process that begins at engagement acceptance and continues throughout the current audit engagement."

Paragraph 7: Two more items should be added to the matters that may affect the auditor's procedures:

- Information to be furnished by the client to the auditor, and the timing of its delivery to the auditor;
- Timing of performance of certain timing-sensitive audit procedures, such as inventory observations and confirmations.

Paragraph 9.b.: The draft stated as "Determine the significant factors that affect the direction of the engagement team." The word "direction" is ambiguous, and could mean supervision, leadership, or objective, among other things. We suggest it be replaced by "focus." A similar change is needed in paragraph 8.

Paragraph 9: Add a fifth consideration in establishing audit strategy:

- Determine skill and experience level required of personnel to be assigned to the audit.

Paragraphs 13 – 15: This section is entitled "Individuals with Specialized Skill or Knowledge." The current focus is solely on IT. The section should be expanded to explicitly include other specialties, such as valuation and actuaries.

Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement

Question 6: *Does the proposed standard clearly and adequately describe the auditor's responsibility for performing risk assessment procedures?*

Response: Yes. No specific comment.

Question 7: *Are the additional procedures in paragraph 13 that the auditor should consider performing when obtaining an understanding of the company and its environment reasonable and appropriate for audits of issuers? Should these procedures be specifically required for all audits, or is the responsibility to consider performing the procedures sufficient?*

Response: Yes. The additional procedures as stated are reasonable and appropriate. The responsibility to consider performing the procedures is sufficient, so the procedures should not be individually required. However, the Board should consider including an additional procedure in paragraph 13 that the auditor should consider performing, as follows:

- Reviewing summaries of risks and the company's evaluation of those risks identified through the company's risk management processes.

This addition would direct auditors' attention to the company's own risk management processes and assist the auditors in obtaining the required understanding of the company's operations. If the company has implemented risk mitigation activities, this knowledge would help the auditors assess the risks and internal controls related to financial reporting.

Question 8: *Is the new requirement to assess certain matters related to the control environment component of internal control over financial reporting reasonable and appropriate? Is the difference between the required performance for an audit of internal controls over financial reporting and an audit of financial statements only clear?*

Response: Yes. The new requirement to assess certain matters is reasonable and appropriate. The difference between the required performance for an audit of internal control over financial reporting and an audit of financial statements only is reasonably clear.

Question 9: *Is the additional direction regarding the period-end reporting process reasonable and appropriate for audits of financial statements only?*

Response: Yes. No specific comment.

Question 10: *Are the requirements and direction regarding the auditor's responsibilities for evaluating design and implementation of controls as part of obtaining an understanding of internal controls over financial reporting sufficient and clear? If not, what additional direction is needed?*

Response: Yes. No specific comment.

Question 11: *Does the additional description of the key engagement team members provide a better understanding of the expected participants in the discussion?*

Response: Yes. No specific comment.

Question 12: *Does the discussion of significant risks in this standard provide sufficient direction to enable auditors to identify significant risks?*

Response: Yes. No specific comment.

Question 13: *Should the proposed standards indicate specific requirements and direction regarding documentation, e.g., summaries of the identified and assessed risks and the linkage to the auditor's responses?*

Response: Yes. No specific comment.

Proposed Auditing Standard – The Auditor's Responses to the Risks of Material Misstatement

Question 14: *Does the proposed standard clearly describe the auditor's responsibilities regarding test of controls in integrated audits and in audits of financial statements only?*

Response: Yes, but refer to additional comments related to Appendix 4 on page 5 of this letter.

Question 15: *Are the requirements and direction regarding tests of controls appropriately aligned with Auditing Standard No. 5?*

Response: Yes, but refer to additional comments related to Appendix 4 on page 5 of this letter.

Question 16: *Does the proposed standard clearly describe the auditor's responsibilities regarding substantive procedures?*

Response: Yes, but refer to additional comments related to Appendix 4 below.

Unnumbered Comment on page A9-26:

The Board seeks comment on whether the list of conditions in Appendix A and the accompanying direction are reasonable and appropriate, and in particular, whether there are conditions in Appendix A that should be added, removed, or modified

Response: Additional specific examples would be helpful. Appendix A lists some items that could not only be an indication that fraud risk assessment needs to be modified, but overall risk assessment should be modified.

Additional Comments Related to Appendix 4:

- Paragraph 15 – The current phrasing of this paragraph may lead auditors to test too many controls that are not important to the conclusion about the effectiveness of the company's internal control over financial reporting. We suggest rather than using the phrase "selected controls" that the guidance provide specific examples of "key" or "relevant" controls.

- Paragraph 18 – Add discussion about "during the entire period of reliance" and what this means.

- Paragraph 19 – Additional guidance is needed with respect to when substantive procedures alone cannot provide sufficient appropriate evidence, specifically when there is heavy reliance on IT.

- Paragraphs 21 and 22 – We suggest the discussion regarding the importance of walkthroughs and the text of paragraphs AS5.37-38 be included in the body of the proposed standard rather than in the footnotes. We suggest the PCAOB include a broader comment regarding the authority of footnotes vs. text of the proposed standard(s) and the protocol for including guidance in footnotes.

- Paragraph 25 – We suggest expanding on the meaning of "tested directly" and also include a discussion about the use of the work of others including receiving direct assistance and use of third parties working under the direction of management/audit committee.

Proposed Auditing Standard – Evaluating Audit Results

Question 17: *Does the proposed standard clearly describe the auditor's responsibilities regarding the evaluation of audit results?*

Response: In general the proposed standards appear to provide additional clarity to the interim standards related to evaluation of audit results.

Paragraphs No. 10 and 11 of this proposed standard might be modified to clarify that any unexpected or unusual results, regardless of whether management's response is vague, implausible, or inconsistent with other audit evidence should be corroborated. (i.e. to make "overall review" standard the same as when performing initial or detailed analytical procedures used as substantive procedures)

It is unclear if the examples of unusual or unexpected analytical relationships listed in Appendix 9 (page A9 – 22) will be included in the final standard? (i.e. will Appendix 9 actually be an integral part of the new standards? (without the questions?)

The wording in the Appendix 9 (page A9 – 22 first paragraph #3) "The conclusions formed from the results of the overall review of the audit are intended to corroborate conclusions formed during the audit of individual accounts and disclosures," appears to capture the objective of this section better than the wording in the proposed standard.

Question 18: *Are the requirements and direction regarding the accumulating identified misstatements and evaluating uncorrected misstatements appropriate and adequate?*

Response: In general the proposed standards appear to provide additional clarity to current standards related to evaluation of audit results.

It would be helpful to footnote "clearly trivial" as synonymous to "clearly inconsequential" as defined in the ISA standard, as done in Appendix 9. We suggest this be done in the body of the proposed standard.

Question 19: *Are the requirements and direction regarding the evaluation of the results of the integrated audit appropriately aligned with Auditing Standard No. 5?*

Response: Yes. No specific comment.

Proposed Auditing Standard – Considerations of Materiality in Planning and Performing an Audit

Question 20: *Are the requirements and direction in this standard appropriately aligned with the concept of materiality as described in the courts' interpretation of the federal securities laws?*

Response: The theoretical elements for determining materiality are sufficiently established within financial reporting frameworks, in particular FASB Concepts Statement No. 2. Inclusion of references to formulations used by the courts in interpreting the federal securities laws, such as those set forth in footnote 2 should be deleted. Guidance provided to auditors ought to be based on promulgated standards as developed within the PCAOB, not the courts. Reference to specific court cases creates a presumption that registered accounting firms ought to become familiar with the myriad of evolving securities litigation, a presumption that is not set forth in the Sarbanes-Oxley Act of 2002, and may require interpretation of legal matters beyond the expertise of registered accounting firms.

Question 21: *Does the proposed standard sufficiently and clearly describe the auditor's responsibilities regarding (a) establishing an appropriate materiality level for the financial statements as a whole and (b) establishing a lower materiality level or levels for particular accounts or disclosures? If not, what additional direction is needed?*

Response: Additional empirical guidance ought to be provided for determining each of the levels of materiality. For example, the discussion contained on page A9-28 in the middle of the first paragraph which discusses the relative importance of net earnings or other financial elements in determining materiality for the financial statements as a whole is useful information that ought to be included in the final standard. In a similar manner, empirical guidance and examples ought to be provided for determining materiality for particular accounts or disclosures. In addition, the PCAOB ought to consider incorporating any previously published interpretive guidance regarding determining materiality, promulgated by itself or the SEC, within the new audit standard.

Question 22: *Is the use of the term "tolerable misstatement" in the proposed standard appropriate and sufficiently clear?*

Response: Footnote 4 of the proposed audit standard refers the reader to paragraph .18 of AU sec. 350, "Audit Sampling." Since the PCAOB is not currently amending this standard, which discusses the concept of tolerable misstatement, we consider the discussion appropriate. However, as set forth in our response to Question 21 above, we recommend that additional empirical guidance or examples be developed for establishing tolerable misstatement as used in tests of details.

Proposed Auditing Standard – Audit Evidence

Question 23: *Does the proposed standard clearly describe the principles necessary for evaluating the sufficiency, relevance, and reliability of audit evidence?*

Response: Yes, the principles are adequately stated.

Question 24: *Are the auditor's responsibilities regarding the authentication of documents reasonable and appropriate?*

Response: Yes, the responsibilities are reasonable and appropriate.

Question 25: *Are the requirements and direction related to selecting items for testing appropriate and clean?*

Response: Yes, the responsibilities are reasonable and appropriate.

Question 26: *Are the five categories of assertions in this standard sufficient or should they be expanded? If so, how would such expansions affect auditor's performance?*

Response: The five identified categories are considered sufficient.

CalPERS
Investment Office
P.O. Box 2749
Sacramento, CA 95812-2749
Telecommunications Device for the Deaf - (916) 795-3240
Telephone: (916) 795-2731

February 18, 2009

J. Gordon Seymour
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street N.W.
Washington, D.C. 20006-2803

RE: **PCAOB Release No. 2008—006 Rulemaking Docket Matter No. 026**
"Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards"

Dear Mr. Seymour:

I am writing you on behalf of the California Public Employees' Retirement System (CalPERS). CalPERS is the largest public pension fund, managing pension and health benefits for more than 1.6 million California public employees, retirees and their families. CalPERS manages approximately $180.9 billion in assets.

The Public Company Accounting Oversight Board (PCAOB, Board) is proposing changes to its auditing standards related to the auditor's assessment of and response to risk. The Board is proposing seven auditing standards that would update the requirements for assessing and responding to risk during an audit.

As a long-term shareowner, CalPERS has a significant financial interest in seeking improvements in the integrity of financial reporting. Auditors play a vital role in helping to ensure the integrity of financial reporting through an audit of financial statements. The objective of an audit of financial statements is to limit audit risk to a low level, so that the auditor can opine with reasonable assurance that the financial statements present fairly, in all material respects, a company's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles (GAAP). The accuracy of financial reports enables investors to have the opportunity to better assess the risks and rewards for their investments.

CalPERS responded in February, 2007 to the Board's request for comment on an audit of internal control over financial reporting being integrated with an audit of financial statements. As reference we *attach CalPERS' February 26, 2007 comment letter*. CalPERS was overall supportive of the adoption of Auditing Standard No 5 and Rule 3525, Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting as reflected in this attached letter. CalPERS also provided a comment letter dated December 17, 2007 strongly recommending that the Commission and PCAOB not weaken investor protections by providing relief to any companies (solely on company size limits) from complying with Section 404 of Sarbanes-Oxley.

Through this letter, CalPERS is supportive of the Board and its efforts to strengthen audit quality by improving the requirements related to risk assessment, the integration of the audit of the financial statements with the audit of internal controls over financial reporting and emphasizing the auditor's responsibilities for considering the risk of fraud during the audit. Additionally, in support of enhanced disclosures relating to risk controls, CalPERS endorsed guidelines developed earlier this year to be applied on a global basis to assist audit committees in fulfilling their responsibilities on audit, risk and control matters. See attachment 2, "Guidelines for Enhanced Disclosure to Assist Directors, Audit Committees, Shareowners and Investors", dated Jan 26, 2009. In the context of these 2 enclosures we support the Board's conforming amendments to the standards.

Lastly, we appreciate the Board's role and ongoing discussions with promotion of high quality audits worldwide and the impact and influence of the International Auditing and Assurance Standards Board's (IAASB) risk assessment standards in its consideration in developing these amendments and proposals put forth in Docket No. 026.

Thank you for considering our comments. If you would like to discuss any of these points please do not hesitate to contact me at 916-795-4129.

Sincerely,

Mary Hartman Morris

Mary Hartman Morris
Investment Officer, CalPERS Corporate Governance

Enclosure: (1) *PCAOB Rulemaking Docket No. 021 – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements – Feb. 26, 2007 comment letter submitted.*
(2) *Guidelines for Enhanced Disclosure to Assist Directors, Audit Committees, Shareowners and Investors- Issued Jan 26, 2009*

cc: Eric Baggesen, Senior Investment Officer – Global Equity, CalPERS
Kenneth W. Marzion – Interim Chief Operations Investment Officer, CalPERS
Bill McGrew, Portfolio Manager – Corporate Governance, CalPERS
Michael Riffle, Portfolio Manager – Corporate Governance, CalPERS

Attachment 1

Russell Read
Chief Investment Officer
Investment Office
P.O. Box 2749
Sacramento, CA 95812-2749
Telecommunications Device for the Deaf - (916) 795-3240
Telephone: (916) 795-3400

February 26, 2007

J. Gordon Seymour
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: Rulemaking Docket Matter No. 021- An Audit of internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, Considering and Using the Work of Others In An Audit

Dear Mr. Seymour:

I am writing you on behalf of the California Public Employees' Retirement System (CalPERS). CalPERS is the largest US Public Pension Fund with total assets of $231.1 billion and more than 1.5 million members. CalPERS is pleased to provide the Board with comment regarding its proposed audit standard on internal controls and financial statement reporting which would supersede Auditing Standard No. 2.

CalPERS supports both section 404 of the Sarbanes-Oxley Act of 2002 and the Public Company Accounting Oversight Board's efforts to enforce adherence to its requirements through issuing this proposed auditing standard which would integrate the audit of internal control over financial reporting with an audit of financial statements. CalPERS submits this comment letter to assist the PCAOB with understanding the interest a large institutional investor has in the proposed standard.

In the fall of 2006, CalPERS provided the SEC some recommendations to ensure adherence by all public companies with the requirements of Section 404. We believe Section 404 of the Sarbanes-Oxley Act of 2002 contributes to the establishment of certainty necessary for investors to maintain confidence in the integrity of a public company's financial statements. CalPERS believes the PCAOB proposed standard is integral for ensuring the integrity of a public company's financial statements. We support the PCAOB with this proposed standard and agree with:

- Emphasizing the importance of risk assessment - emphasizing a top-down, risk-based approach. We strongly agree that auditors should apply the appropriate focus on controls to prevent and detect fraud. We agree with the Board that auditors should evaluate the risk of management override and mitigating actions and determine whether a material weakness exists.

- Clarifying the definitions of significant deficiency and material weakness. We believe this will assist in eliminating any inconsistencies of evaluation and application among audit firms.

- Clarifying the role of materiality by illustrating that the auditor should plan and perform the audit of internal control using the same materiality measures used in the audit of the annual financial statements.

- Permitting consideration of knowledge obtained during previous audits since the auditor will be emphasizing a top-down, risk-based approach adjusting the nature, timing and extent of testing in subsequent years commensurate with the risk.

- Allowing the independent auditor to rely more on the work of others, particularly after the initial audit of internal controls has been completed.

- Adopting proposed Rule 3525 which requires Audit Committee pre-approval of services related to internal control. Just as CalPERS strongly supported the provisions in the proposed rule requiring additional emphasis on the Audit Committee to ensure the independence of the external auditor regarding tax services; CalPERS fervently supports:

    - Describing in writing to the Audit Committee the scope of the proposed service on internal control;
    - Discussing with the Audit Committee the potential effects of the proposed service on internal control on the firm's independence; and
    - Documenting the substance of the firm's discussion with the Audit Committee.

CalPERS believes that having greater transparency in the decisions made by the Audit Committee permits greater investor oversight as well as improves confidence in the capital markets.

Internal Controls are designed and owned by management of a company. We continue to support SEC rules implementing Section 404 of the Act requiring management to evaluate the effectiveness of internal controls. CalPERS does not believe the auditor evaluating management's annual evaluation process is redundant of the opinion on internal control itself or that it contributes to the complexity of the standard and confusion regarding the scope of the auditor's work. Rather, this evaluation of management's review ensures the integrity of a robust review by management and assists the auditor in determining the "tone at the top." Additionally, in our fall 2006 letter to the SEC, we supported the annual certification of processes directly related to the risk of a material weakness and of processes that contribute to the restatement of financial statements.

We encourage the PCAOB not to include dollar limits on the size of a company. This conflicts with a principle based approach and could lead to a tiered approach. We believe one standard is needed for all companies.

CalPERS is prepared to provide assistance to the PCAOB at its request. Please contact Dennis Johnson, Senior Portfolio Manager–Corporate Governance at (916) 795-2731 if there are questions or if we can be of further assistance.

Sincerely,

Russell Read
Chief Investment Officer

Cc: Fred Buenrostro, Chief Executive Officer, CalPERS
Anne Stausboll, Assistant Executive Officer, CalPERS
Christy Wood, Senior Investment Officer, CalPERS
Peter Mixon, General Counsel, CalPERS
Dennis Johnson, Senior Portfolio Manager, CalPERS

ENHANCED DISCLOSURE WORKING GROUP

GUIDELINES FOR ENHANCED DISCLOSURE TO ASSIST DIRECTORS, AUDIT COMMITTEES, SHAREOWNERS AND INVESTORS

January, 2009

ENHANCED DISCLOSURE WORKING GROUP

GUIDELINES FOR ENHANCED DISCLOSURE TO ASSIST DIRECTORS, AUDIT COMMITTEES, SHAREOWNERS, AND INVESTORS

INDEX

The Working Group would welcome any views and feedback. Please e-mail us at enhanceddisclosure@standardlife.com

PREFACE

The Global Auditor Investor Dialogue[1] recognises the need to restore confidence in the current economic climate and sees enhanced disclosures relating to accounting, audit and risk controls as having a pivotal role in achieving this. Accordingly, certain Dialogue members agreed to convene an independent working group to develop guidelines, which would focus primarily on disclosure and be capable of general application on a global basis, to assist not only boards and audit committees in fulfilling their responsibilities, but also investors and shareowners in their evaluation of annual reports and constructive engagement with companies on audit, risk and control matters. Members' intent is that the guidelines should compliment and support the contributions in this area by regulators and others. It is important to emphasise that they are guidelines not standards, and should be used as such, with flexibility and professional discretion.

The guidelines are intended to provide a practical tool, which should be tailored to circumstances of each company – for example, whether a company has a one-tier or two-tier board structures. Although the guidelines focus on companies with a one-tier board structure, it is recognised that in a two-tier structure many of the guideline provisions fall within the remit of the management board. Therefore, it is intended that the supervisory board would exercise appropriate oversight to monitor compliance.

Whilst early consideration and implementation of the guidelines is encouraged, the Working Group is very mindful of the increasing burden of responsibilities on boards, in general, and audit committees, in particular. That said, it is hoped that companies, directors, investors and shareowners will find the guidelines to be helpful and useful in respect of annual reports published in 2009 and beyond.

The Working Group is indebted to those who gave of their time to contribute their views during the development of the guidelines – their views helped to highlight deficiencies, temper the tone and otherwise bring valuable insights to bear.

Last but not least, the Working Group values greatly the endorsement of the organisations listed in Appendix I. Their support is invaluable and was never taken for granted and never will be. If others wish to give their endorsement, they would be very welcome[2].

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[1] The Global Auditor Investor Dialogue is an informal forum whose members comprise the major global auditing networks and leading global investors and share owners. These guidelines may or may not represent the views of the individual Dialogue members.

[2] Any organisation wishing to endorse these guidelines is invited to send details to enhanceddisclosure@standardlife.com

Information Flows to the Audit Committee

An audit committee's effectiveness is conditioned by the quality of information it receives from management in order to reach informed judgements on key risks and issues. This is especially important in the credit crunch environment in respect of information relating to cash flow, debtors, asset valuation and impairment testing. Management has a responsibility to ensure that it fairly presents to the audit committee all material information that might influence its decisions and it should confirm to the committee and the board that it has done so. In the event that there are significant areas for improvement that the audit committee has asked management to address then it would be useful if this were disclosed.

The audit committee members should enhance their understanding of the information it receives by visiting relevant areas of the company where appropriate.

Guideline #1

The audit committee should identify the information it needs to enable it to fulfil its responsibilities, which should be reviewed and analysed with an independent mindset, so that the committee is confident as to the completeness and integrity of the information it receives. The information should be provided to it in a timely manner and in a format which is complete, understandable and reliable.

The audit committee should confirm to shareowners and investors that it has received sufficient, reliable, and timely information from management to enable it to fulfil its responsibilities.

Risk & Internal Controls

Many companies provide a comprehensive description of their risk management and internal control systems, including whistle-blowing policies. In this regard, shareowners and investors find it useful to have a summary of the principal risks, especially when their potential impact is quantified. Also, they are concerned to know that the audit committee (or other relevant board committee) considers that the risk management and internal control systems are adequate and are operating properly. In making its assessment it is particularly important that the audit committee properly understands any financial instruments and structured products held by the company, in order to be able to identify the corresponding risks. Shareowners and investors are mindful of the considerable resource which has to be committed by independent non-executive directors to fulfil this responsibility but wish to be assured, without prejudicing the commercial interests of the company, that the responsible committee has the right blend of skills to identify and prioritise the most relevant risks and exercise effective oversight.

Guideline #2

The board, audit committee, or other relevant board committee should disclose what steps it has taken to satisfy itself that the risk and control framework and processes are operating, and have operated, properly. It should disclose a summary of the process it has applied (directly or through relevant committees) in reviewing the operation of the system of internal control and confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from that review. The scope should encompass business model, financial, operational and behavioural risks and incentives which impact on the achievement and evaluation of appropriate key performance indicators (KPIs).

Valuation of Assets and Liabilities

The increased use of fair value accounting and its pervasive significance have presented challenging issues for issuers, auditors and users of audited financial statements. The Working Group believes that the role of the audit committee is of critical importance to ensuring that a robust and appropriate approach is taken to the valuation of assets and liabilities (including contingent and off balance sheet items), and that adequate and appropriate disclosure, including a description of the inherent financial risks, is provided in the financial statements and the notes thereto. The audit committee should consider using independent experts to scrutinise the fair values which are proposed by management.

Guideline #3

The audit committee should provide reasonable assurance that the significant assumptions used for determining fair values have been scrutinised and, where appropriate, challenged by the audit committee. In addition, the audit committee should confirm that they have satisfied themselves that the markets and/or models to which the valuations are marked have liquidity and transaction profiles that are adequate and sufficiently robust for enabling reliable and relevant valuations to be determined. Also, that they are satisfied that there is meaningful disclosure of critical judgements and key estimates.

Where values deviate from available market values, the audit committee should minute its general considerations, the information which provided the basis thereof, and its final endorsement. Periodically, these considerations can and should undergo a careful ex-post examination. The audit committee should ensure that shareowners and investors are provided with an unbiased explanation of the factors which account for any significant deviation from previously reported values.

Write-Downs and Impairment Provisions

In addition to determining the primary valuation of assets and liabilities, management – and auditors – make significant judgements on write-down and impairment charges. The board and its audit committee have oversight responsibility to determine whether the process for write-downs and impairment provisions is adequate and appropriate. In particular, in respect of goodwill and other intangible assets, the audit committee should ensure that the process for determining the valuation takes into consideration the prevailing economic conditions.

Guideline #4

The audit committee should provide a brief, informative discussion of the factors which they have taken into account and the considerations they have made when fulfilling their responsibilities in respect of endorsing material write-downs and impairment provisions.

The audit committee, and ultimately the board, should carefully weigh other factors that might have influenced management's proposed write-downs and provisions with a view to satisfying itself that management's proposals are consistent with a true and fair presentation, free from bias, and take into consideration prevailing economic conditions.

Securitisation, Off-Balance Sheet and Contingent Liabilities

Investors and shareowners expect that there will be fair and unbiased disclosure of securitisation and off-balance sheet vehicles,[3] and contingent liabilities in the audited financial statements, since these vehicles and liabilities can be material to a company's financial position and, when appropriate, applicable regulatory capital ratios. Notwithstanding audit committees sometimes fail to give these items and their disclosure adequate attention, which can have serious adverse financial consequences.

Guideline #5

[3] Fundamentally, investors and share-owners do not encourage off-balance sheet vehicles and other such arrangements and expect them to be kept to a minimum.

The audit committee should satisfy itself that all material securitisation arrangements, off-balance sheet liabilities and contingent liabilities have been identified for financial reporting purposes and that they are disclosed in sufficient detail in the financial statements, in accordance with any applicable accounting standards. The audit committee should critically assess and, when appropriate, challenge the valuations ascribed to these liabilities, and the methodologies used to determine them, to satisfy itself that the valuations used are fair and reasonable. The audit committee report should contain a meaningful description of the work it has undertaken in this regard.

Internal and External Auditors

It is critical to the integrity of audited financial information that both the internal and external audit functions are evaluated effectively at least annually. In the current climate, shareowners and investors need to be assured that the audit functions are effective and have been robustly evaluated; the evaluations should encompass a review of audit quality. In this context, it is recognised that the internal audit function has finite resources. It should focus on its principal responsibilities which are different from those of the external auditors, whose role is to express an opinion on the financial statements.

In addition, on a continuing basis, the audit committee must satisfy itself as to the independence of the external auditors and as to the adequacy of disclosures and analysis of non audit fees.

Guideline #6

The audit committee should disclose when and how periodic formal evaluations of the internal and external auditors were undertaken and of the key conclusions arising therefrom[4]. The external auditors should be subject to annual evaluation and the audit committee should provide a convincing, informative and non boiler plate explanation which supports its choice of auditor.

If the external auditor should change, the board or the audit committee, as appropriate, should promptly disclose the change and provide an informative explanation of the reasons for it.

Executive Compensation & Risk

[4] A number of professional bodies publish review checklists such as the Institute of Chartered Accountants of Scotland's publication "Appraising your Auditors".

When addressing the financial crisis, many regulators, commentators and others have called into question executive compensation policies and practices which may incentivise executive behaviour that has been counter-productive to maintaining a well controlled, sustainable enterprise. Although determining compensation and remuneration policies and practices is primarily the responsibility of compensation and remuneration committees, the audit committee has an important role to assist these committees in ensuring that compensation policies and practices are consistent with an effective control environment. In particular, the board and/or the audit committee should satisfy itself that key finance, control and risk management personnel do not have inappropriate performance incentives – and only appropriate ones. In fulfilling this responsibility, regard should be had to KPIs, as referred to in Guideline #2 (Risk and Internal Controls)

Guideline #7

The audit committee should provide (a) a brief but informative description of its interaction with the compensation or remuneration committee in respect of executive compensation policies and practices and (b) comfort that the compensation policies and practices for top executives, key business unit leaders and senior control and risk management personnel are, in its opinion, appropriate for maintaining a robust control environment, consistent with good stewardship, and the long-term objectives and risk appetite of the company.

Substance not Form

A persistent criticism of many audit committee reports is the use of boilerplate language that fails to reflect the breadth and depth of the important activities undertaken. This is a barrier to effective accountability and transparency. Far better that the audit committee provides a useful and engaging account of the activities it has undertaken.

Guideline #8

The audit committee should provide a non-boilerplate report that provides an useful and engaging account of its activities, giving informative emphasis to key audit issues and how they are managed. All members of the committee and particularly the chairman are encouraged to take an active role in writing the audit committee report.

Audit Committee Charter

Many companies make their audit committee charter available on their website or include it in their proxy statement. Investors and shareowners welcome such disclosure but they are concerned to ensure that the charter remains 'fit for purpose', especially in the current economic environment. Mindful of the inherent complexities of accounting and auditing standards, and the significance of the judgements that have to be made in implementing them, the charter should enable the audit committee, at its sole discretion, and when it reasonably believes it necessary to do so, to obtain external independent advice at the company's expense so that it can fulfil its responsibilities with assured confidence.

Guideline #9

The board and audit committee should undertake annually a considered and in depth review of the audit committee charter, which should be disclosed on the company's website and, where appropriate, be included in their proxy statement, and satisfy themselves that it provides the terms of reference to enable the audit committee to fulfil its responsibilities. The board and the audit committee should disclose that the charter has been reviewed and summarise any changes that have been made to enable the audit committee to fulfil its responsibilities.

The audit committee should confirm that its charter permits it to obtain independent external advice at the company's expense and it should disclose whether or not it has obtained such advice. In addition, the audit committee should confirm that it has fulfilled its responsibilities under its charter.

Audit Committee Membership

Investors and shareowners want to be assured that the audit committee membership is reviewed at least annually. In addition, that it comprises one or more members – preferably one of whom is the chairman of the committee - who have relevant and recent financial expertise as well as relevant commercial experience. Furthermore, the independence of the committee is a cornerstone – indeed, investors generally prefer that all members of the audit committee are independent. It is vital that the committee members receive regular training to ensure they maintain their competence and credentials, and keep abreast of auditing, accounting, and relevant risk issues.

Special care and attention is required in these regards when addressing the membership of audit committees of financial services companies. Such companies often have complex activities involving complex products, for which the quality of auditing is essential and valuation is heavily dependent on applicable accounting practices as well as the ability to determine whether valuation data is relevant and robust – relevant commercial expertise is invaluable in this context. It would be a matter of significant concern if the audit committee of a financial services company did not have at least two experts, one of whom should have accounting expertise in financial services.

Also, it is important the board itself has the skill sets and competencies which will enable a knowledgeable discussion and exchange of views on the matters raised by the audit committee for the board's consideration.

Guideline #10

The board should disclose that it has reviewed the audit committee's composition during the year, and that it is satisfied that the audit committee has the expertise and resource to fulfil effectively its responsibilities, including those relating to any risk and controls.

Furthermore, the board should provide a convincing and informative explanation to support its opinion that the audit committee has not only recent and relevant financial and audit experience but also the commercial, financial and audit expertise to help it assess effectively the complex accounting, audit and risk issues it has to address. Any changes to the composition of the audit committee should be promptly disclosed and explained.

APPENDIX I

ENDORSING ORGANISATIONS

The undernoted organisations have kindly endorsed the Guidelines for Enhanced Disclosure.

International Corporate Governance Network (ICGN)

Eumedion

Railpen Investments

California Public Employees' Retirement System (CalPERS)

Standard Life Investments

Any organisation wishing to endorse these guidelines is invited to send details to enhanceddisclosure@standardlife.com

APPENDIX II

WORKING GROUP MEMBERS

Kenneth Bertsch *	Morgan Stanley Investment Management
Gerben Everts *	APG Investments
Guy Jubb * (Convenor)	Standard Life Investments
Mary Hartman Morris *	California Public Employees' Retirement System (CalPERS)
Isabelle Santenac *	Ernst & Young

* Member of The Global Auditor Investor Dialogue

CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

February 18, 2009

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: Request for Public Comment: *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk*, and *Conforming Amendments to PCAOB Standards*, PCAOB Rulemaking Docket Matter No. 026

Dear Office of the Secretary:

The Center for Audit Quality (CAQ or the Center) is a public policy organization that seeks to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for reform that are rooted in the profession's core values of integrity, objectivity, honesty, and trust. We also seek to improve the reliability of public company audits and to enhance their relevance for investors in this time of increasing globalization and financial complexity. Any U.S. accounting firm registered with the Public Company Accounting Oversight Board (PCAOB or the Board) may join the CAQ. The CAQ is affiliated with the American Institute of Certified Public Accountants (AICPA) and has approximately 800 U.S. public company audit firms as members, representing tens of thousands of professionals dedicated to audit quality.

We welcome the opportunity to share our views on the PCAOB's Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk (the proposal or proposed standards).

Identifying, assessing and responding to risks are integral to the audit process and fundamental to the conduct of high quality audits. We concur with the Board that risk assessment, appropriately applied, should underlie the entire audit process and result in appropriate audit procedures that are tailored to a company's facts and circumstances, including its size and complexity. We also appreciate the Board's efforts to consider recommendations made to the profession on potential ways to further improve risk assessment (e.g., the 2000 report by the Panel on Audit Effectiveness, and feedback from the PCAOB's Standing Advisory Group (SAG)). Some of these same recommendations served as the impetus for the AICPA's Auditing Standards Board (ASB) and the International Auditing and Assurance Standards Board (IAASB) to form a joint task force in 2001 that culminated in the development of a common set of risk assessment auditing standards intended to improve audit quality and to support convergence of auditing standards. We support the Board's objective to update its extant interim standards to reflect improvements that firms have made in risk-based audit methodologies and improvements in standards by other standards setters.

In the remainder of our letter, we have organized our overall observations and concerns about the proposal around the following topical areas:

- Convergence of auditing standards
- Importance of auditor application of professional judgment
- Risk assessment process: consistency and integration with Auditing Standard No. 5 (AS 5)
- Organization and content of standards
    - Objectives
    - Appropriate balance between requirements and guidance
    - Inconsistent use of terminology
    - Definitions
    - Use of notes to paragraphs and appendixes
- Considerations related to the finalization of the proposed standards
    - Overall review of interim standards
    - Effective date.

In addition, we have comments and recommendations regarding codification of the PCAOB's standards and increased public involvement in the PCAOB's standards setting process, particularly by the use of task forces with representatives from the profession, other standards setting bodies, and other interested parties as the proposed standards are being developed.

Finally, we have comments that are specific to each of the seven proposed standards and the conforming amendments, which we have included as an Attachment to this letter.

Convergence of Auditing Standards

We fully support the Board's consideration of the work of other standards setters, as evidenced by the overall alignment of the proposal's general structure with the corresponding risk assessment standards of the IAASB and the ASB. We also recognize the efforts of the Board to participate in the work of other standard setters by attending and participating in IAASB meetings, inviting the IAASB Chairman to join the SAG meetings, and participating in joint meetings of standards setters.

While we acknowledge the significant steps taken, we urge the PCAOB to advance efforts towards convergence by using the International Standards on Auditing (ISAs) as the base from which to develop standards and adding to or modifying the ISA wording for specific requirements and guidance deemed necessary for the purposes of auditing U.S. public companies.

We believe that doing so has several benefits. For instance, such a process can enhance the effectiveness and efficiency of all standards setters; improve the global understanding of auditing standards both by auditors and by other interested parties; eliminate unnecessary differences among the standards; and clarify the rationale for and understanding of differences that remain, such as those necessitated by an integrated audit performed for legal or regulatory reasons. These benefits will enhance auditors' understanding, implementation, and consistent application of standards on *all* the audits they perform, not just those subject to the Board's oversight. Additionally, appropriate convergence allows firms to avoid unnecessary costs, for example, by allowing for synergies related to training, implementation, and the development and maintenance of quality control systems that accommodate the standards of the various standards-setting bodies.

We acknowledge and strongly support the analysis of significant differences in requirements between the Board's proposed standards and those of the corresponding ISAs. In light of the increasing global acceptance of the ISAs, we believe that, prospectively, the Board should provide a more detailed comparison of its proposed standards and those of the IAASB. This could be achieved, as recommended above, by starting with the comparable ISA in developing the Board's standards. It would facilitate a more robust comparison of the standards and clearly identify where, and why, the Board believes divergence from the ISAs is necessary for audits of issuers.

We strongly support the following remarks made by Board member Bill Gradison at the Board's October 21, 2008 open meeting that encourages the development of comparative information that clearly states how the standards differ between the three standard setters:

> “For the first time, the PCAOB is putting out a new standard for comment that includes an extensive comparison of its proposal with the standards promulgated by another standard setter, in this case the Risk Assessment Auditing Standards of the International Auditing and Assurance Standards

> Board -the so-called ISAs. I would hope that the PCAOB would continue to put out such comparative information in connection with future proposals for new PCAOB standards. We are fast entering an auditing environment with three differing standards, especially as the PCAOB gradually replaces its interim standards (the pre-2003 ASB standards) and the ASB revises its standards, using the ISAs as the base - that is, "ISAs plus." I don't know whether over the long run having three standards is sustainable, but as long as there are three standards I believe each standard setter has a responsibility to make it as clear as possible how its standards differ from those of the other two standard setters so that practitioners know what is expected of them. Today's Board action is, in my mind, a constructive step in that direction."

Our detailed comments included in the attachment to this letter identify areas in which we believe additional constructive steps toward greater convergence could be achieved without jeopardizing the Board's objective to issue robust standards directed to audits, including integrated audits, of issuers.

Importance of Auditor Application of Professional Judgment

We acknowledge and agree with the Board's recognition in its release accompanying the proposed standards of the importance to the audit process of auditors exercising sound professional judgment to determine how best to fulfill the requirements of the proposed standards under particular circumstances. We also acknowledge the Board's statement in paragraph A19 of the appendix to Auditing Standard No. 3, *Audit Documentation*, that "….because professional judgment might relate to any aspect of an audit, the Board does not believe that an explicit reference to professional judgment is necessary every time the use of professional judgment may be appropriate." We believe it is important to discuss the integral role of the auditor's professional judgment, particularly within these proposed standards which establish the foundational principles of the audit, and which are dependent on the use of professional judgment to appropriately apply the standards to the unique circumstances of each audit engagement. We believe it is important to recognize that the judgments made regarding the identification and assessment of risks, determination of the nature, timing and extent of audit procedures, and what constitutes sufficient evidence are necessarily dependent on the facts and circumstances known to the auditor during the conduct of the engagement.

We set forth a recommendation below for the Board to develop a new standard based on ISA 200 (Revised and Redrafted), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* (see discussion of Objectives under the "Organization and Content of Standards" topic). In addition to the reasons described below for doing so, an additional benefit would be to incorporate guidance from that ISA that describes the role of and encourages the use of the auditor's professional judgment in fulfilling the objective of obtaining reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an

opinion. Professional judgment is essential to the proper conduct of an audit because the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances.
Additionally, with the importance of professional judgment in mind, our comments on the proposed standards identify certain guidance that we believe is unnecessarily prescriptive and could have the unintended consequence of encouraging a checklist mentality rather than the exercise of professional judgment to appropriately scale and tailor the risk assessment process in each audit.

Risk Assessment Process: Consistency and Integration with Auditing Standard No. 5 (AS 5)

We believe that in an integrated audit the risk assessment *process* is the same for both the audit of the financial statements and the audit of internal control over financial reporting (ICFR). The fundamental requirements to obtain an understanding of the entity, including its internal control, and its inherent risks as a basis for assessing the risk of material misstatement are applicable in both the financial statement and ICFR audits. Once the risks of material misstatement have been identified, the auditor's *responses* to those risks may differ depending on whether an integrated audit or a financial statement only audit is performed.

We believe that the Board's proposed risk assessment standards may encourage a "side-by-side," rather than an integrated, approach to risk assessment for auditors performing an integrated audit. We encourage (see comment 1a in the Attachment to this letter) the Board to reconsider ways in which to better integrate its guidance for performing an integrated audit. We understand that the proposed standards are intended to be suitable for audits only of financial statements as well as for audits of financial statements as part of an integrated audit. However, we find that the Board's approach to combining the proposed standards with AS 5 is inconsistent and in some cases confusing.

One major inconsistency is that the top-down approach permeates AS 5 but is not mentioned in the proposed risk assessment standards. We believe that the top-down approach is relevant to the audit of the financial statements even when not performing an integrated audit, and should be addressed by the Board in the proposed standards.

We also believe that the guidance about the auditor's understanding of the components of internal control in the proposed standard *Identifying and Assessing Risks of Material Misstatement* should be better aligned with related guidance in AS 5. In particular, AS 5 paragraphs 34-38, "Understanding Likely Sources of Misstatement," and paragraphs 22-27, “Identifying Entity-Level Controls" are different enough from the guidance on understanding the components of internal control in the proposed standard *Identifying and Assessing Risks of Material Misstatement* that they suggest a parallel, rather than integrated, understanding is necessary to identify and assess risk in the audit of ICFR and the financial statement audit.

In addition, there is considerable redundancy between guidance in the proposed standards and that in AS 5 that we believe should be eliminated. If guidance incorporated from AS 5 is equally relevant to an audit only of financial statements, it should be incorporated into the risk assessment standards and through a conforming amendment removed from AS 5 with a cross-reference to the risk assessment standards. An example of such guidance is the bullet points in paragraph 7 of the proposed standard *Audit Planning and Supervision*, which are incorporated, with very slight modification to broaden their scope to an audit of financial statements, from paragraph 9 of AS 5. In contrast, there is guidance incorporated from AS 5 into the proposed standards that would be relevant only when the auditor is performing an integrated audit. In such circumstances we believe that the guidance should remain in AS 5. An example of such guidance is paragraphs 41-44 of the proposed standard *Evaluating Audit Results*.

Organization and Content of Standards

Objectives

We support the use in each of the standards of an "objective of the auditor" that is principles based and outcome oriented to assist the auditor in performing the audit in accordance with PCAOB standards. We believe that it is necessary for the PCAOB to consider from the outset how the objectives of individual standards are intended to fit into the overall framework of PCAOB standards. In the ISAs, for example, objectives of individual standards are intended to assist the auditor in planning and performing the audit to achieve the overall objectives of the audit set forth in ISA 200. As stated in paragraph 20 of ISA 200, the auditor should use the objectives in relevant ISAs to: (a) determine whether any audit procedures in addition to those required by the ISAs are necessary in pursuance of the objectives stated in the ISAs; and (b) evaluate whether sufficient appropriate audit evidence has been obtained.

In addition, we believe that the Board should consider adding objectives to each of its standards, not just the seven in the proposal, and similarly link them to an overarching standard that provides context for their use. As such, we recommend that the PCAOB propose and adopt a standard equivalent to ISA 200. Such a standard would:

- Establish the auditor’s overall responsibility when conducting an audit
- Set out the overall objectives of the auditor
- Explain the nature and scope of the audit and the inherent limitations of an audit
- Explain the scope, authority, and structure of the PCAOB standards, including language that denotes requirements
- Include a discussion of the use of professional judgment.

This can be achieved in part by using the proposed standard *Audit Risk in an Audit of Financial Statements* as a starting point and, using ISA 200, adding any additional content, as determined necessary by the Board, regarding the responsibilities and functions of the independent auditor and reasonable assurance in the context of U.S. public company audits.

In addition, we believe that objectives should articulate a statement of purpose. We do not believe it is appropriate or necessary for objectives in individual standards to contain the "must" or "should" terminology governed by the Board's Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*. Such words should be reserved for the requirements that support the objectives of the standards. Accordingly, we recommend that paragraph 3 of the proposed *Audit Planning and Supervision* standard be moved from the "objective of the auditor" section of the proposal and incorporated as requirements under the "planning an audit" and "supervision" sections of the proposal.

Finally, we believe that some objectives proposed by the Board are overly broad (for example, those in *Evaluating Audit Results* and *Audit Evidence*) and the linkage between others should be improved (see *Identifying and Assessing Risks of Material Misstatement* and *The Auditor's Responses to the Risks of Material Misstatement*).

Appropriate Balance Between Requirements and Guidance

While we generally support the brevity of the proposed standards, there are some areas where we believe the proposal would be improved with additional explanatory guidance, some of which is included in extant PCAOB, IAASB or ASB standards. An example is paragraph 19 of the proposed standard *The Auditor's Responses to the Risks of Material Misstatement,* which requires the auditor to perform tests of controls "for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence" but provides no guidance to explain when such circumstances may arise. We believe the Board should consider including guidance about when this is the case. For instance, we believe this is the case under circumstances where a significant amount of information supporting financial statement assertions is electronically initiated, recorded, processed, or reported, as described more fully in paragraphs A120-121 of ISA 315 (Redrafted), *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment.* In such cases, the entity's controls over such risks are relevant to the audit and the auditor should obtain an understanding of them. This is also described in paragraphs 119-120 of AICPA AU 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*; or in paragraphs 68-69 of the Board's interim standard AU 319, *Consideration of Internal Control in a Financial Statement Audit*.

We also believe that some of the requirements in the proposed standards are unnecessarily prescriptive and will reduce efficiency without an accompanying increase in effectiveness. Such guidance encourages a checklist mentality rather than the appropriate exercise of professional judgment to tailor and scale the risk assessment process in each audit to the circumstances.

An example of an unnecessarily prescriptive requirement is paragraph 52(d) of the proposed standard *Identifying and Assessing Risks of Material Misstatement*, which requires the auditor to make specific inquiries about fraud of "accounting and financial reporting personnel, including, in particular, employees involved in initiating, authorizing, processing, or recording complex or unusual transactions." In AU 316.25 and in paragraph A16 of ISA 240 (Redrafted), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, such personnel are included as an example of others within the entity to whom the auditor may wish to direct fraud inquiries. We agree that the inquiries that are required in paragraphs 52(a), (b), and (c) of management, the audit committee, and internal audit personnel, respectively, are appropriate; however, we believe that the requirement in 52(d) is an inappropriate elevation of guidance that may in some circumstances involve an unnecessarily large number of personnel.

Inconsistent Use of Terminology

"Should consider," "should evaluate," "should assess" and "should take into account"

We observe numerous instances in the proposed standards (for example, paragraphs 37, 41 and 63 in *Identifying and Assessing Risks of Material Misstatement* and paragraphs 4 and 25 in *Evaluating Audit Results*) in which the Board changes "should consider" phrases drawn from its interim standards or from the ISAs to "should evaluate" or "should assess" phrases. By changing the verb, there may be an implication that the PCAOB expects a different auditor action. If this is the case, then we suggest that additional guidance be provided to explain what the expected action is. If this is not the case, then we suggest that the Board use the same verb as is used in the other standards to avoid confusion.

In the proposed standards the Board also makes frequent use of a requirement that the auditor "should take into account" a matter (for example, the Note to paragraph 12 in *Identifying and Assessing Risks of Material Misstatement*, paragraphs 5 and 9 in *Consideration of Materiality in Planning and Performing the Audit*, and paragraphs 37 and 48 in *The Auditor's Reponses to the Risks of Material Misstatement*). We ask the Board to clarify both the auditor action and the documentation that the Board expects of the auditor as a result of this presumptively mandatory responsibility.

Definitions

We encourage the Board to develop and follow a consistent approach with respect to defining terms. Some of the proposed standards (for example, *Identifying and Assessing Risks of Material Misstatement*) define terms in a Definitions section similar to the redrafted ISAs. Others define terms informally within the text of the standard (for example, the definition of fraud risk in paragraph 4(c) of *The Auditor's Responses to the Risks of Material Misstatement*). AS 5 demonstrates a third approach with a Glossary of defined terms appended to the standard. We believe that these differences in approach make the standards more difficult to use and could lead to misunderstanding. We recommend that the Board consistently define terms in a special Definitions section of each standard, as appropriate, and create an overall Glossary of Terms for PCAOB standards that would contain all defined terms.

Use of Notes to Paragraphs and Appendixes

We do not understand the purpose of including Notes in various paragraphs. We recommend that guidance that is in Notes be placed in existing or new paragraphs. We also recommend that there should be limited use of appendixes within a standard (necessary guidance should be included in the full text of the standard), and that no requirements be included in any appendix.

Considerations Related to the Finalization of the Proposed Standards

Overall Review of Interim Standards

We support the Board's intent, announced at its October 2008 SAG meeting, to issue a concept release for public comment in early 2009 addressing the Board's action plan for review of its interim standards. Due to the foundational nature of the proposed standards, we suggest that the Board consider feedback on that concept release in connection with making revisions to these proposed standards prior to adoption.

Effective Date

The Board did not propose an effective date. In developing an effective date, we encourage the Board to consider the importance of providing firms sufficient time to incorporate the standards into their audit methodologies and training programs prior to implementation. We also believe that it is necessary for the Board to expose the proposed implementation date for public comment prior to adoption of the standards.

Codification of the PCAOB's Standards

We acknowledge the Board's stated efforts to write standards that will serve as a foundation for future standards setting. However, we have difficulty envisioning how these standards will be integrated with the Board's other interim standards and with Auditing Standards 1-6. It may become increasingly cumbersome to navigate and apply the proposed standards with the extant standards without a codification.

Adoption of these proposed standards introduces a third "style" of standard that is inconsistent with the Board's other standards without a clear vision for integrating the standards in the future. For example, some standards have objectives and others do not; some standards have terms defined in a Glossary that is appended to the standard, others have terms defined in a Definitions section of the standard, and others have terms that are defined informally within the text of the standard. The IAASB and the ASB both have undertaken projects (the IAASB's is nearing completion; the ASB's is in progress) to redraft all their auditing standards in a consistent manner with the intent of encouraging greater understanding, and more consistent application, of their standards by auditors to promote audit quality. We encourage the Board to undertake a similar project to introduce greater consistency and clarity in its standards.

Public Involvement in the Standards-Setting Process

We strongly encourage the Board to increase the depth and accelerate the timing of public involvement, including the auditing profession, in its standards-setting process. We believe that this can be done effectively without compromising the independence of the Board’s standard setting process. We acknowledge the important role that the Board's SAG and its inspection process play in informing the Board's agenda. We also strongly support the remarks of Board Member Dan Goelzer, at the PCAOB's October 21, 2008 open meeting at which the proposed standards were approved for exposure, that the Board might consider additional steps to promote transparency of its process. Mr. Goelzer suggested potential actions such as publishing a revised proposal, opening a second comment period and holding additional public forums or Board discussions to consider the comments. The Board could also improve the transparency of the standard setting process by providing direct word-for-word comparisons of proposed standards and new standards to current interim standards so as to highlight how the proposal is intended to change current audit practice, and having the Board more publicly debate/discuss the various issues when considering the standards.

We believe the Board could improve its standard setting process by establishing external task forces with significant expertise, including members of the auditing profession, to participate in developing and updating its auditing standards. This would provide the Board with an opportunity for periodic public input from interested persons or organizations in the development stage, prior to the formal publication of a proposed standard for public comment. We believe that such a process would enhance the timeliness and efficiency of the development process. We further encourage Board members or staff to participate in joint task forces with the IAASB and the ASB. We believe that such initiatives would complement, not diminish, the role of the SAG and the other forums that currently inform the Board's agenda and standard setting activities. Some advantages of such an approach include:

- The ability to vet alternatives with various constituents while preserving the ability to obtain broader input on such issues prior to the public exposure of a document,
- The possibility to achieve greater convergence of the Board's standards with global and U.S. non-public company auditing standards, and
- An enhanced understanding of the rationale for differences that are not eliminated in standards.

* * * *

Enclosed with this letter is an Attachment that provides more detailed comments specific to each of the proposed standards and the conforming amendments. These detailed comments are intended as a complement to the issues outlined and described above.

We appreciate the opportunity to comment on the proposed standards and would welcome the opportunity to respond to any questions you may have regarding any of our comments and recommendations.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

Enclosure

cc: PCAOB
Mark W. Olson, Chairman
Daniel L. Goelzer, Member
Willis D. Gradison, Member
Steven B. Harris, Member
Charles D. Niemeier, Member
Thomas Ray, Chief Auditor and Director of Professional Standards

cc: SEC
Chairman, Mary Schapiro
Commissioner Luis Aguilar
Commissioner Kathleen L. Casey
Commissioner Troy Paredes
Commissioner Elisse B. Walter
James Kroeker, Acting Chief Accountant
Shelly Parratt, Acting Director of the Division of Corporation Finance

ATTACHMENT
COMMENTS ON PROPOSED STANDARDS

Below are more detailed comments specific to each of the seven proposed standards and the conforming amendments to PCAOB standards. To facilitate your review, we have matched the detailed comment to the related topical area in the body of our letter. In some instances, however, a comment does not relate back directly to a topical area, in which case none is noted

	Appendix 1: Audit Risk in an Audit of Financial Statements	**Topical Area**
1a	Paragraph 1 – As stated in paragraph 1 and its accompanying note, this proposed standard establishes requirements and provides direction regarding the auditor's consideration of audit risk in an audit of financial statements. The paragraph note states that AS 5 establishes requirements and provides direction regarding the auditor's consideration of risk in an audit of internal control over financial reporting (ICFR). This suggests that there are two separate and distinct processes for considerations of risk in an integrated audit. We believe many of the risk assessment activities are the same for both the audit of ICFR and the audit of the financial statements. An auditor's risk assessment includes obtaining an understanding of the entity and its environment, including its internal control, and assessing the risks of material misstatement. These fundamental requirements are applicable in both the audit of ICFR and financial statement audits. Once the risks of material misstatement have been identified, the auditor's responses to those risks may differ depending on whether an integrated audit or financial statement only audit is performed. We believe this is the intention of the Board; however, the drafting of paragraph 1 and the accompanying note create a different impression. We encourage the Board to reconsider ways in which to better integrate its guidance for performing an integrated audit.	**Integrated Audit Guidance**
1b	Paragraph 2 – In describing the objective of the auditor paragraph 2 states "The objective of the auditor is to conduct the audit of the financial statements in a manner that reduces audit risk to an appropriately low level." This objective relates to the overall objective of the auditor when performing an audit, and does not specifically relate to the subject matter or title of this standard which is *Audit Risk in an Audit of Financial Statements*. Although the topics included in this proposed standard relate to the overall audit, we note that important guidance related to the overall audit is not included, such as a description of reasonable assurance and the inherent limitations of an audit. As discussed above in our overall comments we suggest this proposed standard be incorporated into an overall	

	objectives standard and that additional information about an audit be incorporated into such a standard.	
1c	Paragraph 5 – The proposed standard defines the risk of material misstatement as referring to “the risk that the financial statements are materially misstated due to error or fraud.” This definition differs from the ISA and ASB definitions which describe the risk of material misstatement as “the risk that the financial statements are materially misstated *prior to the audit*.” Including the words “prior to the audit” makes it clear that the risk of material misstatement is the entity’s risk. We recommend adding the words “prior to the audit” to the definition of risk of material misstatement.	**Convergence**
1d	Paragraph 6 – The proposed standard does not sufficiently describe the types of risks of material misstatement at the financial statement level and how to identify such risks. In order to provide sufficient guidance to auditors regarding the risk assessment process, we believe the PCAOB should include in this standard additional guidance similar to that included in ISA 315 paragraphs A98-A101 related to identification and assessment of risks of material misstatement at the financial statement level.	
1e	Paragraphs 9 and 10 are inconsistent with each other and with paragraph 13 of the proposed *Audit Evidence* standard. The first sentence in paragraph 10 suggests that the auditor’s ability to reduce detection risk is limited to the performance of substantive procedures alone, rather than all audit procedures. Paragraph 9 refers to “procedures performed by the auditor” and to “audit procedures.” In the proposed *Audit Evidence* standard, paragraph 13 states that audit procedures can be classified as falling into three categories: risk assessment procedures, tests of controls and substantive procedures. Because the first sentence in paragraph 10 implies that detection risk is only reduced through the performance of substantive procedures, and the concept of how to reduce detection risk is sufficiently explained in paragraph 9, we believe the first sentence in paragraph 10 should be deleted.	

	Appendix 2: Audit Planning and Supervision	**Topical Area**
2a	Paragraph 3—We recommend the Board move paragraph 3 of the proposed standard from the "objective of the auditor" section of the proposal and incorporate it as requirements under the "planning an audit" and "supervision" sections of the proposal.	**Organization**
2b	Paragraph 3—We recommend the Board review its standards for consistency in the use of "must" and "should." For example, AS 5 paragraph 9 states that "the auditor should properly plan the audit of internal control over financial reporting and properly supervise any assistants," but paragraph 3 of the proposed standard states that "the auditor must adequately plan the audit and properly supervise the members of the engagement team."	**Organization**

2c	Paragraph 7—This paragraph includes a list of matters and states the auditor "… should evaluate whether the following are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures." However, this list includes items related to auditor judgment and audit planning (the first, fifth and ninth bullets) that would not have a bearing on the company's financial statements or ICFR, but rather they would be relevant to the auditor's risk assessment and planning activities. As such, we recommend revising the paragraph accordingly.	**Organization**
2d	Paragraph 7—Included in the list of matters in paragraph 7 is "preliminary judgments about the effectiveness of internal control over financial reporting." Unlike the bullet point related to materiality in paragraph 7, this bullet is not clear that it refers to the auditor's judgments. We recommend the Board modify this bullet item to clarify that it pertains to the <u>auditor's</u> preliminary judgments.	
2e	Paragraph 7—We acknowledge that the matters in paragraph 7 are largely equivalent to those listed in AS 5, paragraph 9. To eliminate redundancy and unnecessary inconsistencies, we suggest conforming amendments be made to AS 5 to eliminate this requirement from AS 5 in order to eliminate repetitious guidance.	**Integrated Audit Guidance**
2f	Paragraph 9b—This paragraph states that in establishing the overall audit strategy, the auditor "should…determine the significant factors that affect the direction of the engagement team." We understand this to mean a supervisor's direction or supervision of the team, but the wording is not as clear as it could be. In addition, the comparable guidance in paragraph 7 of ISA 300 (Redrafted), *Planning an Audit of Financial Statements*, requires that the auditor "shall… consider the factors that are significant in directing the engagement team's efforts." The use of the phrase "should consider" provides the auditor with clear expectations of the specific thought process and action required. We suggest re-wording this phrase to "should…consider the factors that are significant in directing the engagement team's efforts."	**Organization**
2g	Paragraph 10—This paragraph states "the auditor should develop a written audit plan." The term "written" can be misleading in the age of electronic workpaper documentation. In addition, this creates an unnecessary inconsistency with the standards of IAASB and ASB, neither of which includes the word "written" in relation to the audit plan. We recommend the Board replace the phrase "develop a written audit plan" with "develop and document an audit plan".	
2h	Paragraph 11—We support the Board providing guidance for multi-location engagements. Appendix B of AS 5 also contains multiple location scoping guidance, which we believe can be helpful in an audit of financial statements as well as an audit of ICFR. We encourage the Board to incorporate the multiple location guidance from Appendix B of AS 5 into the proposed standards. Alternatively, the Board should clearly state how	**Integrated Audit Guidance**

	the proposed guidance differs from, or is the same as, the multi-location considerations related to the audit of internal control, and how the auditor should use it in combination with the guidance in AS 5.	
2i	Paragraph 11—This paragraph lists factors an auditor "should evaluate" regarding the selection of a particular location or business unit when multiple locations exist. This represents a change from the "should consider" requirement drawn from its interim standards to a "should evaluate" requirement. We ask the Board to clarify its expectation of auditors with respect to "should evaluate" in its proposed standard as distinct from "should consider" guidance in its interim standards, both in terms of the specific thought process or action required of the auditor, including the related documentation.	**Organization**
2j	Paragraph 12—This paragraph uses the term "fraud risk", but does not define this term. It is defined in other proposed standards. We recommend the Board replace the phrase in paragraph 12 "… or the discovery of a previously unidentified fraud risk" with the phrase "…or the discovery of a previously unidentified risk of material misstatement due to fraud ("fraud risk")."	**Integration of Fraud Guidance**
2k	Paragraphs 13-15——These three paragraphs address the auditor's responsibility to evaluate whether specialized skill or knowledge is needed in assessing risks, applying audit procedures, or evaluating the results. We have the following comments pertaining to the guidance in this area: • As noted in Appendix 9 of the proposal, the Board extended this responsibility from a similar requirement in AU 311.10 regarding specialized information technology (IT) skill or knowledge. Appendix 9 indicates the Board acknowledged the requirement was necessary because of the prevalent use of individuals with specialized skill or knowledge in areas other than IT, such as forensic specialists, valuation specialists, and actuarial specialists. However, these examples are not included in the proposed standard. We believe it would be helpful to auditors to include these examples in Paragraph 13. • Paragraphs 14 and 15 address the use of a specialist to evaluate the effect of IT on the audit. We support the inclusion of this guidance, carried forward from AU 311.10 and AU 319.31-32. We recommend the Board also incorporate a reference to the extant guidance in AU 336, *Using the Work of a Specialist*, to address more comprehensively the auditor's consideration of using individuals with specialized skills and knowledge, other than accounting and auditing.	
2l	Paragraphs 18-20 – These paragraphs provide an example of using multiple "should" statements when it is not necessary. Paragraph 18 establishes the requirement by stating "the engagement partner should supervise other engagement team members…." Paragraphs 19 and 20 provide detail on how the requirements stated in paragraph 18 should be fulfilled but do so through additional "should" statements. We believe the	**Organization**

	initial "should" statement in paragraph 18 is appropriate and sufficient to impose the requirement. We recommend that paragraphs 19 and 20 be presented as application guidance for paragraph 18. For instance, paragraph 19 should be revised to begin with "Elements of supervision include…." and paragraph 20 should be revised to state "the level of supervision of other engagement team members depends on many factors including…" We recognize the proposed standard retains extant requirements regarding supervision from AU 311 of the interim standards. We believe our suggestions would help streamline the proposed standard, thereby increasing an auditor's understanding, implementation, and execution of the proposed standard.	
2m	Paragraph 21—The first sentence of paragraph 21 states that the partner and team members "should make themselves aware" of certain procedures to be followed when there are differences of opinion among the team. This phrase is unclear as to what the auditor should actually do. We recommend the Board be more specific in its requirements.	**Organization**

	Appendix 3: Identifying and Assessing Risks of Material Misstatement	**Topical Area**
3a	Paragraph 3 - We recommend that the Board adopt an objective similar to the following from ISA 315 in order to provide the important linkage between identifying and assessing risks and designing and implementing responses to those risks: "The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion level, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement."	**Convergence**
3b	Paragraph – 4 – The definition of significant risk in the proposed standard is different than that of the ISAs. The definition in the proposed standard does not refer to "identified and assessed" risks, but rather just refers to "risks." The resulting implications are unclear. We believe the definition of significant risk should use the phrase "identified and assessed" risk. The entire concept of a "significant risk" in the auditor's risk assessment process is that the auditor identifies and then assesses that risk, and then plans the audit procedures according to the "identified and assessed" risks.	**Convergence**
3c	Paragraph 4b - We recommend that the Board acknowledge the necessary use of professional judgment in determining significant risks. We believe the definition of significant risks provided in paragraph 4b of the proposed standard should include language similar to that used in paragraph 109 of ISA 315, which states "the auditor should determine which of the risks	

	identified are, in the auditor's judgment, risks that require special audit consideration" (emphasis added).	
3d	Paragraphs 8 -19 - The proposed standard does not appear to acknowledge consistently that there may be significant differences based upon size or complexity of companies with respect to understanding the company and its environment and the related factors noted in paragraphs 8 through 19. While the proposed standard acknowledges that there may be differences between smaller and larger companies with respect to the company's measurement and review of its financial performance (for example, see note to paragraph 17) we believe there also may be significant differences in the other areas discussed in the proposed standard. Accordingly, we recommend that the Board's final standard broadly acknowledge that the procedures performed by the auditor in identifying and assessing risks of material misstatement may vary between smaller, less complex entities and larger, more complex entities.	
3e	Paragraph 10 – The proposed standard does not acknowledge that ongoing matters, in addition to significant changes, may affect the identification and assessment of risks of material misstatement. We recommend that the proposed standard be revised to acknowledge that ongoing matters (i.e., those matters that may have been significant in a prior year and are present in the current year) should be considered in the risk identification and assessment process.	
3f	Paragraph 12 - When considered along with paragraphs 8, 9a and 9b, this paragraph results in an obligation on the auditor to obtain an understanding of each of the items in the list. This is an example where the proposed standard imposes a number of requirements relative to items the auditor "should consider," "should consider performing," or where the auditor's understanding of an area "includes" a number of listed items. It is unclear whether the use of these terms imposes a documentation requirement on the auditor. We believe that providing examples of items that may be considered by the auditor (similar to paragraph 15 of the proposed standard) allows the auditor to appropriately tailor his or her audit approach. In addition, the Note to this paragraph states that the auditor "should take into account" information obtained from this understanding when determining the existence of related parties. We ask the Board to clarify both the auditor action and the documentation that the Board expects of the auditor as a result of this presumptively mandatory responsibility.	
3g	Paragraph 16 - We do not believe the proposed standard is clear with respect to the auditor's responsibility in identifying and assessing risks relative to company performance measures. Although as stated in paragraph 16 of the proposed standard, the purpose is to identify those performance measures that affect the risks of material misstatement, the second bullet of paragraph 17 seems to shift the auditor's focus to those measures the company uses as controls. We recommend that the Board	

	more precisely define the auditor's responsibilities with respect to these matters.	
3h	Paragraph 19 – We believe the Board should describe what is meant by "degree of transparency of the application of accounting policies" or delete that bullet.	
3i	Paragraph 34 - There are a number of instances where the proposed standard highlights differences between the required audit procedures to be performed in an integrated audit compared to an audit of only financial statements. In particular, the note to paragraph 34 states that "For purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than that which is normally obtained in an audit of financial statements only." This statement pertains only to an integrated audit and should be deleted from the proposed standard. We recommend the Board clarify that the process of identifying and assessing risks of material misstatement is the same in an integrated audit and in an audit of financial statements only. The proposed standard does not emphasize the use of a top-down approach to identifying and responding to risks of material misstatement. As noted in AS 5, "A top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal controls over financial reporting. The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures." We believe the use of a top-down approach is fundamental to the process of identifying and assessing risks of material misstatement. We recommend that the Board acknowledge the importance of the use of a top-down approach in identifying and assessing the risks of material misstatement. Paragraphs 34 - 38 of AS 5 provide for certain basic risk assessment activities to be undertaken to identify risks at the assertion level. The proposed standard does not contemplate the risk assessment activities noted in paragraphs 34 through 38 of AS 5. We recommend that the Board acknowledge the importance of the use of the risk assessment activities noted in paragraphs 34 through 38 of AS 5 in identifying and assessing the risks of material misstatement.	**Integrated Audit Guidance**
3j	Paragraph 41 – The proposed standard states that "The auditor should assess whether information obtained in other engagements performed by the auditor is likely to be important for identifying risks of material misstatement." It is unclear whether the second use of the term "the auditor" in this sentence refers to the audit engagement partner, or the audit firm. As a result, it is unclear whether the auditor has a responsibility to assess information obtained in any other engagements performed by the	

	audit firm, including any non-audit services provided. We recommend the Board use language similar to that found in paragraph 8 of ISA 315, which states "Where the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement."	
3k	Paragraph 56 (c) – The proposed standard states that the auditor should "evaluate the types of potential misstatements…" We recommend that the PCAOB incorporate the concept of asking "what could go wrong?" consistent with paragraph 30 of AS No. 5. We believe the consistent use of this terminology would enhance clarity and promote uniformity of application.	
3l	Appendix A – The reasons for this guidance appearing in an Appendix rather than the standard itself are unclear. Paragraphs A1 and A4-A6 contain presumptively mandatory responsibilities for the auditor. If the appendix is intended to hold the same authority as the standard, it should be incorporated into the standard, particularly those paragraphs that contain presumptively mandatory responsibilities. We recommend that the Board incorporate the Appendix A guidance into the body of the standard, or remove the presumptively mandatory requirements therein.	**Organization**

	Appendix 4: The Auditor's Responses to the Risks of Material Misstatement	**Topical Area**
4a	Paragraph 1 - The description in paragraph 1 omits a crucial element in responding to risk – the notion of the auditor's ***identification and assessment*** of the risk of material misstatement. We understand that the Board considered this matter and concluded that obtaining sufficient appropriate evidence to support the auditor's opinion requires the auditor to adequately respond to the risks of material misstatement. However, we do not believe that this approach appropriately makes the connection between the assessment of risk and the audit response. For instance, in each audit the auditor performs risk assessment procedures to determine where risks of material misstatement exist, and based on this assessment the audit response is designed and implemented to obtain sufficient appropriate evidence. The effectiveness with which this assessment is performed logically affects any audit response. By eliminating this connection between assessment and response, the standard would not explicitly require a linkage between the auditor's responses and the assessed risks of material misstatement. We believe that the notion of linkage is a fundamental concept of the audit risk process that enhances the quality of an audit. We recommend that the standard include the concept of linkage, that is, the auditor should design and implement appropriate responses based on the *identified and assessed* risks of material misstatements, which is	**Convergence**

	consistent with ISA 330 (Redrafted), *The Auditor's Responses to Assessed Risks*.	
4b	Paragraph 3 - We recommend rephrasing the objective included in paragraph 3 of the proposed standard to better reflect an outcome based approach that provides both specificity and a link between the requirements of the standard and the objective of the auditor. As such, we suggest using wording similar to ISA 330, which states "The objective of the *auditor is to obtain sufficient appropriate audit evidence* about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks."	**Convergence**
4c	We support the addition of guidance to assist auditors in achieving the objective of this standard and suggest including selected sections of the guidance from the publication, *Staff Views – An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit Of Financial Statements*: *Guidance for Auditors of Smaller Public Companies*, Chapter 1, *Scaling the Audit for Smaller, Less Complex Companies.* In particular, this publication contains guidance that describes the attributes of smaller companies that have less complex operations which affect the particular risks and controls implemented to address those risks. Some examples are: the use of entity level controls to achieve control objectives; consideration of the risk of management override; implementation of segregation of duties and alternative controls; the use of IT; the maintenance of financial reporting competencies; and the nature and extent of available documentation to support operating effectiveness of controls.	
4d	Paragraphs 14 – 16 - Paragraphs 14 and 15 of the proposed standard focus on testing controls specific to an audit of internal control only. Additionally, paragraph 16 focuses on evidence about the effectiveness of controls in an audit of internal control. We recommend removing this guidance from the proposed standard and retaining it solely in AS 5.	**Integrated Audit Guidance**
4e	Paragraph 18 - Footnote 14 to paragraph 18 provides guidance about the "period of reliance" with respect to testing controls in a financial statement audit. Given the importance of this concept, we believe this guidance should be included within the body of the standard and that implementation guidance about how this concept would be applied should be provided. The application guidance in ISA 330, paragraph A32, provides an example of how evidence pertaining only to a point in time may be sufficient for the auditor's purpose and explains that controls over the entity's physical inventory counting at the period end may be an example of such a control.	
4f	Paragraph 19 - This paragraph states that tests of controls should be performed in the audit of the financial statements for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence. The circumstance when such a situation might occur is not described. To clarify the intent of this presumptive requirement we suggest including an example similar to that contained in ISA 330, paragraph A24, which states that "In some cases…the auditor may find it	

	impossible to design effective substantive procedures that by themselves provide sufficient appropriate evidence at the assertion level. This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system." Paragraph 19 also indicates that assessing completeness and accuracy is limited to substantive analytical procedures, but the auditor may need to test completeness and accuracy of data when performing other types of procedures, including tests of details. As such, this paragraph should be revised accordingly.	
4g	Paragraphs 14-39 - The guidance related to testing controls contained in paragraphs 14 through 39 is partially directed towards a financial statement audit (paragraphs 17-20), partially directed towards an internal control audit (paragraphs 14-16), and certain paragraphs seem to apply to both situations (paragraphs 21-39). As presented, it is confusing and difficult to follow. It is particularly confusing, as much of this guidance is already included in AS 5. In order to clarify how controls should be tested in a financial statement audit, the proposed standard should not repeat guidance already included within AS 5, but instead incorporate the paragraphs that apply to audits of financial statements in this standard. Additionally, a codification should be provided so that practitioners can easily follow the standards and meet the performance requirements. A codification would clarify what is applicable for financial statement audits and what is applicable for integrated audits.	**Integrated Audit Guidance** **Codification**
4h	Paragraph 37 - When controls have been tested in prior audits, paragraph 37 provides guidance about the factors to be considered to determine the evidence needed in the current year audit to support the auditor's control risk assessment. However, the factors listed are both specific factors related to subsequent years' audits and factors that should be considered whether or not the control was tested previously. We note that this paragraph does not reference the concept of risk in a similar manner as the guidance provided in paragraphs 46 and 47 of AS 5. It also seems to exclude some relevant risk factors that are included within these paragraphs, for example, the nature and materiality of the misstatements that the control is intended to prevent or detect and the degree to which the control relies on the effectiveness of other controls. To appropriately describe the relationship of risk to the evidence to be obtained we recommend including the guidance contained in paragraphs 46 and 47 of AS 5 in this standard and separately describing the overall risk factors related specifically to subsequent years' audits. In addition, this paragraph states that when controls have been tested in past audits, the auditor "should take into account" certain factors to determine the evidence needed in the current year audit. We ask the Board to clarify both the auditor action and the documentation that the Board expects of the auditor as a result of this presumptively mandatory responsibility.	**Integrated Audit Guidance**
4i	Paragraph 41 - The last sentence of the note to paragraph 41 states "Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the ***assertion and the***	

	effectiveness of the control" (emphasis added). However, when discussing dual-purpose tests, this note should discuss forming a conclusion about the "objective of the *substantive test* and effectiveness of the control," not the "*assertion* and the effectiveness of the control."	
4j	Paragraph 48 - This paragraph states that the auditor "should take into account" a number of factors when determining whether it is appropriate to perform substantive procedures at an interim date. We ask the Board to clarify both the auditor action and the documentation that the Board expects of the auditor as a result of this presumptively mandatory responsibility.	

	Appendix 5: Evaluating Audit Results	**Topical Area**
5a	Paragraph 2 – We agree with the PCAOB's approach to include in the proposed standard requirements relating to evaluating the results of the audit, which have previously existed in a variety of standards. However, we note that the inclusion of the broader array of requirements has resulted in an objective in the proposed standard that may be perceived as broader, less specific, and weaker than the objective in ISA 450 (Revised and Redrafted), *Evaluation of Misstatements Identified During the Audit*. Furthermore, when taken together, the objectives of the ISAs in the group of standards from which the requirements are drawn are more comprehensive than the single objective in the proposed standard. The objectives in the ISAs provide context to the auditor in determining whether additional work is necessary to achieve the individual objectives. A broad objective, like the one in the proposed standard, does not provide such context. We suggest the Board incorporate the specific objectives related to each of the individual components in paragraph 5. We also believe that the objective should reference the requirement for the auditor to determine whether he or she has obtained sufficient appropriate audit evidence, similar to the statement in paragraph 1. We believe that these suggestions will strengthen the objective, and also provide appropriate context to the requirements.	**Organization**
5b	Paragraph 3a – We are concerned that the proposed definition of "error" differs from the definition in the accounting literature. We do not believe a separate definition is necessary in the auditing literature. We believe the difference between fraud and error can be clearly delineated in the definition of "misstatement" as proposed below.	
5c	Paragraph 3b – The term "misstatement" appears to be defined using the concept of materiality. As currently written, the first sentence of the definition may be understood by some to be a statement of fact, or may be understood to be a definition of "material misstatement." To clarify, we	**Convergence**

	believe the term should be defined absent of a reference to itself and absent of the concept of materiality. A separate definition of material misstatement could be provided. We suggest the terms "misstatement" and "material misstatement" be defined as follows: Misstatement - A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should have been reported in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. Material Misstatement - A misstatement that, individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework.	
5d	Paragraphs 4 and 25 – The requirements in the related paragraphs in the ISAs (paragraph 27 of ISA 330 and paragraph 12 of ISA 700) state that the auditor "shall consider." The Board has chosen to change the guidance to "shall evaluate" in paragraph 4 and "shall assess" in paragraph 25. By changing the verb, there may be an implication that the PCAOB expects a different auditor action. If this is the case, then we suggest that additional guidance be provided to explain what that expected action is. If this is not the case, then we suggest that the PCAOB use the same verb as is used in the other standards to avoid confusion.	
5e	Paragraph 8 – The proposed standard includes requirements pertaining to the performance of analytical procedures in the overall review of the financial statements. We concur with these requirements. However, we request additional clarification with respect to the requirement in paragraph 8, which states "The nature, timing, and extent of the analytical procedures that should be performed during the overall review depend on the nature of the company and its industry." Although this may be true, the performance of analytical procedures in the final review stage of the audit tend to be similar to the analytical procedures performed during risk assessment. The ISAs also state that such analytical procedures "…may be similar to those that would be used as risk assessment procedures." Without such clarification, the requirement in paragraph 8 may lead to inconsistency in practice with respect to the type of analytical procedures performed to meet the aim of the requirements in paragraphs 6 and 7, even when AU Section 329, *Analytical Procedures*, will be revised to only address substantive analytical procedures.	**Convergence**

5f	Paragraph 13 – This paragraph could be enhanced by further clarifying that "clearly trivial" is not another expression for "not material" (ISA 450, paragraph A2). Although this paragraph is consistent with extant standards and the concept of "clearly trivial" is well understood by auditors in practice, we believe the ISAs provide added clarity from a standards-setting perspective.	**Convergence**
5g	Paragraph 14 - The use of the term "identified misstatements" can be misinterpreted. Although we believe this term is meant to include known or factual misstatements, it is a new term in the literature that is not defined and does not specifically correlate with extant standards or the ISAs. The auditor can "identify" known or factual misstatements, as well as other potential or likely misstatements, such as those relating to projections of sampling applications and judgments relating to estimates. We urge the Board to consider using either "known and likely misstatements," or "factual, judgmental and projected" misstatements, or "accumulated misstatements." It is important to distinguish between these types of misstatements, as the auditor's response differs. In this regard, it may also be helpful to define the terms used.	**Convergence**
5h	Paragraphs 16 and 18 – These paragraphs could be strengthened by requiring the auditor to request management to correct misstatements accumulated during the audit. These requirements would promote accurate financial reporting. In addition, from our perspective, the ISAs create a stronger standard by including such requirements (ISA 450, paragraphs 8 and 12).	**Convergence**
5i	Paragraph 19 - The proposed standard uses the words "<u>detected</u> in prior years" instead of "<u>related</u> to the prior year" as used in ISA 450, paragraph 11. We believe this changes the meaning since there may be misstatements detected in the current year and related to the prior year, which would be encompassed in the ISA language, but not the PCAOB language. We also believe the requirement does not accurately capture the requirements in the Securities and Exchange Commission's Staff Accounting Bulletin 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. We believe the ISA was drafted to be framework neutral and therefore, does not clearly address the iron-curtain versus the roll-over method. PCAOB standards, however, should be clear in this regard.	**Convergence**
5j	Paragraphs 28 and 29 – These paragraphs are included under the heading *Assessing Bias in Accounting Estimates* specifically for purposes of assessing the qualitative aspects of the company's accounting practices. Paragraph 28 deals with whether a misstatement exists in an accounting estimate, and not bias. This paragraph, on its own, is insufficient for determining whether a misstatement in an accounting estimate exists. As written, it might more appropriately be included in the section	

	"Accumulating and Evaluating Identified Misstatements." With respect to paragraph 29, we understand that this requirement is similar to existing requirements. However, we believe the IAASB has made, in ISA 700, *Forming an Opinion and Reporting on Financial Statements*, further improvements in the area of the consideration of bias in the financial statements that should be considered by the PCAOB. Although the proposed suite of risk assessment standards addresses bias throughout, we believe such standards lack application guidance with respect to the indicators of management bias and its effect on the audit. It would be helpful to provide additional examples of management bias. It would also be helpful to clarify that, in addition to the fact that a misstatement due to fraud may exist, the indicators of bias may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate, and whether the financial statements as a whole are free from material misstatement. Such guidance is particularly important in light of the requirement in paragraph 25 for the auditor to "assess" bias. We prefer the language in the ISAs, which requires the auditor to review the judgments and decisions made by management to identify whether there are indicators of possible management bias because the auditor action is clearer.	
5k	Paragraph 32 – We believe that this requirement would be more appropriately placed in Appendix 3, *Identifying and Assessing Risks of Material Misstatement*. Paragraph 30 already addresses the requirement to evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of fraud risks and the need to modify the audit procedures to respond to those risks. We propose moving paragraph 32 into the aforementioned standard and including a footnote reference to that standard in paragraph 30. The reference to Appendix A in paragraph 32 could also be moved to paragraph 30. We further suggest replacing the phrase "earlier in the audit" in paragraph 30 with the phrase "throughout the audit."	**Integration of Fraud Guidance**
5l	Paragraph 37 – This paragraph addresses the auditor's responsibility when the auditor has not obtained sufficient appropriate audit evidence. We believe this requirement can be enhanced by relating it to the financial statements being audited. To be consistent with the ISAs (ISA 700, paragraph 17), the introductory phrase should read as follows: "If the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement..."	**Convergence**
5m	Paragraphs 41 - 44 – These paragraphs unnecessarily repeat requirements and guidance already included in AS 5. Since these paragraphs relate to integrated audits, we suggest deleting them from the proposed standard.	**Integrated Audit Guidance**

	Appendix 6: Consideration of Materiality in Planning and Performing an Audit	**Topical Area**
6a	Paragraph 3 – The Note to Paragraph 3 states "When performing audit procedures, the auditor should be alert for misstatements that could be qualitatively material….However, it ordinarily is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors." The term "ordinarily" suggests that there are situations where it may be practical to base materiality solely on qualitative factors. We suggest removing the word "ordinarily" because we do not believe there would be any situation in which it would be practical to design audit procedures to detect misstatements that are material based solely on qualitative factors, with no regard to quantitative materiality.	
6b	Paragraph 5 - The Note to this paragraph states that the auditor "should take into account" effects of known or expected changes in the company's financial statements when establishing materiality. We ask the Board to clarify both the auditor action and the documentation that the Board expects of the auditor as a result of this presumptively mandatory responsibility.	
6c	Paragraphs 8 and 9 require the auditor to determine the amount of "tolerable misstatement." Paragraph 12 of ISA 320 (Revised and Redrafted), *Materiality in Planning and Performing an Audit*, uses the term "performance materiality" for essentially the same concept, as does an exposure draft of the ASB. Since these terms seem to have the same meaning, we recommend the PCOAB replace the term "tolerable misstatement" with "performance materiality" to avoid confusion.	**Convergence**
6d	Paragraph 9 - This paragraph states that the auditor "should take into account" information about misstatements that were accumulated in audits of prior periods in determining tolerable misstatement, and planning and performing audit procedures. We ask the Board to clarify both the auditor action and the documentation that the Board expects of the auditor as a result of this presumptively mandatory responsibility.	

	Appendix 7: Audit Evidence	**Topical Areas**
7a	Paragraph 1 – This paragraph states "This standard establishes requirements and provides direction regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence." Unlike paragraph 1 in ISA 500 (Redrafted), *Audit Evidence*, the PCAOB does not expressly state that the standard "explains what constitutes audit evidence." Divergence from the ISA is unnecessary. To make it clear that this standard explains what constitutes audit evidence, and to be consistent with the ISA, the Board should add this language to paragraph 1.	**Convergence**

7b	Paragraph 3 – The objective in paragraph 3 is overly broad. As written it relates to the entire audit, rather than this standard. The focus of this proposed standard is on designing and performing audit procedures to obtain sufficient appropriate audit evidence, and this should be reflected in the objective of the standard. Accordingly, we recommend revising this paragraph by using the language in paragraph 4 of ISA 500 which states "the objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion." We acknowledge that paragraph 4 of the PCAOB's proposed standard is similar to paragraph 4 of ISA 500; however, it seems unnecessary to diverge from the ISA on the objective of audit evidence, as this should be a universal concept.	**Convergence**
7c	Paragraph 6 – This paragraph states that audit evidence **must** be relevant and reliable. This paragraph (and those that define relevance and reliability) does not acknowledge that there are degrees of relevance and reliability. This could be accomplished by deleting the second sentence of paragraph 6. This sentence is not needed in paragraph 6 as relevance and reliability are explained in paragraphs 7 and 8 and deleting this sentence would be more consistent with paragraph 5(b) of ISA 500. Alternatively, the second sentence of paragraph 6 could be revised to state "To be appropriate, the accumulated audit evidence must be both sufficiently relevant and reliable" and the following from ISA 500, paragraph A26 could be added "The quality of audit evidence is affected by the relevance and reliability of the information upon which it is based."	**Convergence**
7d	Paragraph 12 – This paragraph implies that the guidance is different for a financial statement audit and an integrated audit. We do not believe this is the intention of the Board. Different assertions are not used based on the type of audit. We believe that the reason for the auditor basing his or her work on different assertions would be the same under either a financial statement audit only or an integrated audit. We suggest clarifying this paragraph.	**Organization**
7e	Paragraph 27 - The proposed standard does not acknowledge that "selective examination of specific items, particularly if those items are selected based on the auditor's belief that they are more likely to contain a misstatement, may provide the auditor with some audit evidence concerning the remainder of the population." (See language in proposed AU 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, paragraph A26). We recommend this language be added to the standard.	**Convergence**
7f	This standard is silent on use of evidence from previous audits. ISA 500 application material acknowledges that information from previous audits may be included in audit evidence. See paragraphs A1, A11, and A26 of ISA 500. The PCAOB should acknowledge that information from previous audits may be used as possible audit evidence	**Convergence**

	Appendix 8: Proposed Conforming Amendments to PCAOB Standards	**Topical Areas**
8a	The PCAOB is proposing to re-title AU section 329, *Analytical Procedures*, to *Substantive Analytical Procedures*, to more accurately reflect the content of the amended standard. We support this amendment, and ask the PCAOB to consider whether AU section 316, *Consideration of Fraud in a Financial Statement Audit*, may also need to be renamed to more accurately reflect the proposed focus on the auditor's responsibility with respect to fraud and more detailed requirements and direction regarding the auditor's responses to fraud risks. This would be in contrast to the current focus of AU 316, which addresses the auditor's overall responsibility related to fraud.	
8b	Appendix 9 states that "AU sections 350.23 through 350.38 have been amended to explain more specifically how the principles in the standard for determining sample sizes when nonstatistical sampling approaches are used." To this effect, Appendix 8 proposes to add paragraph .23A and to add a sentence to the end of paragraph .38 of AU section 350, *Audit Sampling*, that reads "Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample." We believe this proposed sentence implies that auditors would be required to calculate sample sizes using both statistical and non-statistical approaches in all circumstances in order to be in a position to be able to compare the sample sizes. We suggest adding footnote 5 from the AICPA's AU350.23 to clarify that that is not the intent. We also suggest that the PCAOB remove the phrase "or larger than" from the proposed sentence because that phrase would suggest that a non-statistical sample size would have to be at least the same size as a statistical sample (that is it would create a "floor"), which would also drive the auditor to calculate a statistical sample in all cases.	
8c	Appendix 8 proposes to replace paragraph .25 of AU section 350, *Audit Sampling*, with a requirement using the terminology "should evaluate." Extant PCAOB standards use the term "should consider" in the first sentence of this paragraph. By changing the verb, there may be an implication that the PCAOB expects a different auditor action. If this is the case, then we suggest that additional guidance be provided to explain what the expected action is. If this is not the case, then we suggest that the Board use the same verb as is used in AU section 350.25.	
8d	<u>General Comments on Conforming Changes</u> We note that the Board has replaced the term "competent" with the term "appropriate" throughout the extant standards using the conforming amendments. While we agree with this change, the resulting phrase is "sufficient appropriate evidential matter." We believe that the conforming amendments should be revised to replace the entire phrase with "sufficient	

	appropriate audit evidence," which would be consistent with the phrase used in the proposed standards and the related ISAs. We also suggest that the Board make consistent conforming amendments, as necessary, to the Board's other standards (e.g., AS 5).	
8e	<u>AU 316 Conforming Amendments</u> Paragraph 77, items c & d are deleted from extant standard but not included in proposed standards (when the auditor believes misstatement is a result of fraud…*c*. Discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and the audit committee. *d*. If appropriate, suggest that the client consult with legal counsel.) This guidance should not be deleted	
8f	Para 78 - (withdrawing from engagement) has been deleted; there does not appear to be an equivalent in the proposed standards. Again, this guidance should not be deleted from the standard	

Crowe Horwath

Crowe Horwath LLP
Member Horwath International

330 East Jefferson Boulevard
Post Office Box 7
South Bend, Indiana 46624-0007
Tel 574.232.3992
Fax 574.236.8692
www.crowehorwath.com

February 18, 2009

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: **PCAOB Rulemaking Docket Matter No. 026, Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, PCAOB Release No. 2008-06**

Dear Office of the Secretary:

Crowe Horwath LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") proposed auditing standards related to the auditor's assessment of and response to risk and conforming amendments (together the "Proposed Standards").

We support the Proposed Standards, and generally believe adoption is an improvement to existing standards. We also believe that implementation can be completed without undue difficulty as many firms already have in place auditing processes and procedures contemplated in the Proposed Standards. The Proposed Standards will provide value to the users of financial statements by improvement in consistency in delivery of audit services.

However, we believe there are several matters that should be addressed before the Proposed Standards might be adopted. We have provided general observations in the body of this letter, and specific comments on the Proposed Standards in an attachment to this letter. The matters in the attachment are organized by appendix number and paragraph number to expedite consideration. We provide our observations and comments to assist the Board in achieving its goals for these Proposed Standards.

Auditor Judgment

The Proposed Standards effectiveness in operation will largely be determined by auditors' ability to effectively apply reasoned professional judgment. Audits of financial statements have always required the exercise of judgment. We have seen a recent trend in accounting to move from prescriptive requirements toward greater use of judgment, and that trend should also be reflected in auditing standards. To that end, the overall tone of the Proposed Standards is an improvement, but we stress the need for emphasis on use of auditor's professional judgment in assessment of and response to risk. Additionally, risk concepts appropriately allow the auditor to use judgment to determine the resultant testing approach. We note the auditing standard issued by the PCAOB for audits of internal control over financial reporting emphasizes the need for professional judgment in taking a risk-based approach to performing such audits. While the Proposed Standards appear to encourage use of judgment, thus allowing scalability in application to an audit, they are still quite prescriptive and detailed. We recommend the Board review provisions which are now stipulated as requirements that could be optional based on the overall needs of the audit, after applying appropriate auditor judgment.

Convergence of Auditing Standards
Convergence of standards should be a goal in setting auditing standards. We applaud the Board's consideration of the audit risk standards promulgated by the International Auditing and Assurance Standards Board, which are standards commonly used in many other areas of the world. The Proposed Standard includes Appendix 10, "Comparison of Requirements to the Standards of the International Auditing and Assurance Standards Board." Larger firms such as ours are familiar with the international standards. We note that the PCAOB has made extensive efforts in the last several years to reach out to smaller audit firms. Those smaller firms have adopted the Auditing Standards Board's (ASB) audit risk standards and so are familiar with those standards. The ASB may update its risk assessment standards during its clarity project, but we believe that additional guidance and a comparison to the ASB's standards in place now, similar to the content of Appendix 10 for international standards, would be beneficial to smaller firms and we encourage the Board to provide such in any final standard.

Another element of convergence is development of a more cohesive body of standards, recognizing that there may be differences required to reflect law, regulation, or regional economic issues. An example of such a difference required by the PCAOB standards is the requirement for an integrated audit to include internal control over financial reporting. Such differences would be more easily understood and applied if the PCAOB standards were codified into a single set of integrated standards.

* * * * * * * * * * * *

Crowe Horwath LLP supports the Board's efforts to improve its auditing standards with the objective of furthering the public interest. We hope that our comments and observations will assist the Board in its consideration of the Proposed Standard. We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff. If you have any questions on our comments, please contact Wes Williams or Michael Yates.

Cordially,

Crowe Horwath LLP

Crowe Horwath LLP

ATTACHMENT
COMMENTS ON SPECIFIC PROVISIONS OF THE PROPOSED STANDARDS

The following comments are organized by Appendix and Paragraph Numbers in the Proposed Standards.

Appendix 2: Audit Planning and Supervision

Paragraph 15
States *"If an individual with specialized IT skill or knowledge employed or engaged by the auditor's firm participates in the audit, the auditor should have sufficient IT-related knowledge to enable the auditor to:*
b) Evaluate whether that individual's procedures meet the auditor's objectives"
c) Evaluate the results of that individual's procedures as they relate to the nature, timing, and extent of other planned audit procedures
The proposed requirement appears to treat the engagement team member with specialized IT skill as an outside specialist and not part of the engagement team. IT specialists employed by the audit firm are utilized on engagements as part of the engagement team. This paragraph depicts them as separate from the engagement team. We believe they should be involved in fraud brainstorming, planning, and as deemed necessary evaluation of deficiencies as a result of their testing to determine the impact on the nature, timing and extent of audit procedures. This knowledge is and should be shared as part of the audit team process. Thus, for employees of the audit firm, we recommend that items b and c above be reworded to delete reference to "Evaluate" and insert "Understand". We would then encourage the Board to consider adding guidance as presented in paragraph 15 with the use of "Evaluate" for items b and c when the auditors engage outside specialists. Evaluation is in line with the risk associated with the use of an outside specialist and potential disconnect from the audit team.

Appendix 3: Identifying and Assessing Risks of Material Misstatement

Paragraph 56, items d and f
The guidance in identifying and assessing risks of material misstatements in item d and f within this paragraph appear to contradict each other. Additional guidance or clarification on these would be appreciated. Item d provides *"Assess the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statement. Note: In assessing the likelihood and magnitude of potential misstatement, the auditor may take into account the planned degree of reliance on controls selected to test."* The point is made that the planned degree of reliance on controls selected to test can be considered in assessing the likelihood of a misstatement. However, item f provides *"Determine whether any of the identified risks are significant risks. Note: The determination of whether a risk of misstatement is a significant risk is based on inherent risk, without regard to the effect of controls."* The point is made that controls and planned reliance of controls should not be considered when determining significant risks. This appears to contradict the guidance in item d. Appendix 3, paragraph 4 defines Significant Risk as *"A risk of material misstatement that is important enough to require special audit consideration"*. Based on this definition and items d and f, it is unclear whether or not the auditor should take into account planned reliance on controls in the identification and assessment of the risks of material misstatement. For clarity, we recommend the deletion of the Note reference after item d. within this paragraph.

Appendix 4: The Auditor's Responses to the Risks of Material Misstatement

Paragraph 9
The amendment is titled *"The Auditor's Responses to the Risks of Material Misstatement"* and through the first eight paragraphs, when describing misstatements they are always referred to as "material misstatements". However, the word "material" does not appear in the section "*Responses to Fraud Risks*" that starts with paragraph 9. We suggest that for clarity "material" be added to the section title, to read "*Responses to Material Fraud Risks*", as well as added to paragraph nine when referring to "fraud risks". Without this clarity, there is a concern that auditors may conclude they are required to respond to all fraud risks, including those that are not significant.

Paragraph 29
This paragraph provides a listing of matters that could affect the necessary extent of testing of a control in relation to the risk associated with the control. Audit Standard 5 (AS 5), paragraph 47 also addressed factors that affect the risk associated with a control. We believe it would be beneficial to more closely associate these two listings. Whether or not the audit is integrated, understanding the risks that may impact a control is key. Combining the listing from AS5, par. 47 with this would provide more complete guidance of matters to consider.

Paragraph 43
The auditor should be required to consider types of potential material misstatements. However for clarity we believe the word "material" should be inserted prior to "misstatements" in both uses here.

Paragraph 44
This paragraph provides that the auditor must include the following procedure related to period-end financial reporting process: "Examining material adjustments made during the course of preparing the financial statements." This paragraph is not clear if it is intended that all material adjustments are to be examined or if a sampling or judgmental selection of material adjustments can be selected for examination based on a risk based approach. We recommend clarification of this point.

Paragraph 49
This paragraph provides guidance on procedures that should be done if substantive procedures are performed at an interim date. It provides that "Such procedures should include a) comparing relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual and investigating such amounts, and b) performing audit procedures to test the remaining period." Based on the this paragraph, it appears that the use of substantive analytical procedures as described in item "a" is not sufficient to test the interim period "and" other audit procedures are required. We suggest the beginning of this sentence be revised to indicate that the auditor should consider "a." and / or "b." in the design of tests of information from interim to period end. The effectiveness of substantive analytics as described in "a" is based on the expectations and precision levels established. We suggest that after this paragraph, the Board add a Note reference that refers to AU sec. 329 Analytical Procedures and PCAOB Release No. 2004-008 for further guidance in the use of analytics as a substantive audit test. These modifications allow the auditor to determine if analytics is an appropriate test of the data or if other testing strategies need to be implemented.

Paragraph 50
The first sentence does not appear to be structured correctly. We suggest that "detects" be moved in front of "misstatement".

Appendix 5: Evaluating Audit Results

Paragraph 3
The first sentence of *"Misstatements"* includes language for a definition of a material misstatement. We suggest deleting this first sentence as such a definition should be provided in generally accepted accounting principles rather than auditing standards.

Paragraph 15, item b.
The Note states that as "the aggregate of misstatements approaches the materiality level used in planning and performing the audit, there likely will be a greater than an appropriate low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could be material to the financial statements." We concur with this overall notion, but we believe it would be appropriate to change "likely will" to "may". This allows the auditor to use the professional judgment encouraged elsewhere in the Proposed Standards. This assessment takes great effort as is exemplified through the guidance in paragraphs 17-33 of Appendix 5. This concept should not be over simplified by using "likely will" in this sentence.

Paragraph 29
This paragraph discusses the auditing of estimates and the concern that even though estimates individually may be reasonable, there is still a concern that there could be bias on the part of management. The note at the end of the paragraph has a reference to AU secs. 316.63-65. We believe the guidance in paragraph 29 is helpful, however a word was changed in the following sentence in this paragraph compared to the present AU sec 316.63. That changed word significantly alters the responsibility of the auditor.

The sentence in paragraph 29 says (underline added for emphasis): *"However, the auditor should <u>evaluate</u> whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the company's management."*

AU sec 316.63 now provides that (underline added for emphasis): *"…the auditor should <u>consider</u> whether differences between estimates best supported by the audit evidence and the estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management…"*

The use of the term "evaluate" implies a mathematical analysis of all the estimates utilized in an audit and conclusions as to potential bias. As there may be hundreds of estimates in an audit, we are not sure if an evaluation will achieve the Board's objective. The term "consider" allows the auditor to utilize professional judgment based on the estimates within the accounting records and the identified risks.

Appendix 6: Consideration of Materiality in Planning and Performing an Audit

Paragraph 8

In determining tolerable misstatement, auditors use professional judgment in assessing risks associated with accounts and assertions, and consider the overall risk and materiality of the engagement. This paragraph generally supports that thought process except the last sentence, which provides: *"Accordingly, the amount or amounts of tolerable misstatement should be less than the materiality level for the financial statements as a whole and, if applicable, the materiality level or levels for particular accounts or disclosures."* Based on the "and" in the sentence above, materiality levels for particular accounts and or disclosures could not be established higher than the materiality level established for the financial statements as a whole. Materiality is a qualitative as well as quantitative analysis. The above guidance appears to indicate that materiality is a quantitative calculation only and qualitative aspects are not considered at the account or disclosure level. An appropriate change in the sentence noted above, would be as follows: "Accordingly, the amount or amounts of tolerable misstatement should be less than the materiality level established." That provides sufficient guidance and allows the auditor to use professional judgment when assessing and auditing accounts and disclosures. Transactions that only impact a single statement (such as a balance sheet only transaction), may have a materiality level in excess of the materiality established for the financial statements as a whole. Based on the sentence noted above, tolerable error would have to be established utilizing the lowest level of materiality. That approach may cause an auditor to be inefficient in their audit approach and audit the transaction to a precision limit lower than the associated risk. That would defeat the purpose of the risk-based auditing approach in the Proposed Standards.

Paragraphs 10 and 11

We concur with the general nature of audit process suggested in paragraphs 10 and 11. However, paragraph 11 should have a third item added as follows: "3) evaluate the impact, if any, of the lower amount or amounts on the integrated audit (see also paragraph 6)", or that could be added in a note reference. This reminder is important to reinforce that a change in materiality as part of the reassessment procedure may have an impact on the integrated audit under Auditing Standard 5 and could impact controls that were previously evaluated.

Deloitte.

Deloitte & Touche LLP
Ten Westport Road
P.O. Box 820
Wilton, CT 06897-0820
USA

www.deloitte.com

February 18, 2009

Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Request for Public Comment on Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards (PCAOB Release No. 2008-006, October 21, 2008, Rulemaking Docket Matter No. 026)

Deloitte & Touche LLP ("D&T") appreciates the opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB " or the "Board") on its *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards* (PCAOB Release No. 2008-006, October 21, 2008, PCAOB Rulemaking Docket Matter No. 026) (the "Proposed Standards").

The issues presented herein are complex and will likely warrant further discussion to fully understand the implications of particular comments made by us and by other commenters. As such, we encourage the PCAOB to engage in active and transparent dialogue with commenters as the Proposed Standards are evaluated and changes are considered. Such a dialogue will facilitate a more complete understanding of the comments and the consideration of related implications, and, we believe, will ultimately improve the final standards and the auditor's ability to implement them effectively and efficiently. We would welcome such an opportunity to further discuss these matters with the Board and the staff. If you have any questions or would like to discuss these issues further, please do not hesitate to contact James Schnurr at (203) 761-3539 or John Fogarty at (203) 761-3227. We thank you for your consideration of these matters.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: Mark W. Olson, PCAOB Chairman
Daniel L. Goelzer, PCAOB Member
Bill Gradison, PCAOB Member
Steven B. Harris, PCAOB Member
Charles D. Niemeier, PCAOB Member
Thomas Ray, Chief Auditor and Director of Professional Standards

Mary L. Schapiro, SEC Chairman
Luis A. Aguilar, SEC Commissioner
Kathleen L. Casey, SEC Commissioner
Troy A. Paredes, SEC Commissioner
Elisse B. Walter, SEC Commissioner
James L. Kroeker, Acting Chief Accountant
Paul A. Beswick, Deputy Chief Accountant for Professional Practice

Table of Contents

I. Introduction

The Proposed Standards will create the basis for the performance of public company audits in the U.S., and, as a result, this is an important undertaking on the part of the PCAOB. Overall, we support the fundamental concept of a risk-based audit approach, and we support the PCAOB's efforts to improve auditing standards related to the auditor's identification of and responses to risk in the conduct of an audit. While we are supportive of this standard-setting initiative, we believe certain improvements should be made to the Proposed Standards, as described herein.

In the Release to the Proposed Standards, the Board requested comments on a series of matters including (1) whether the Proposed Standards appropriately consider the provisions of the International Standards on Auditing (ISAs) and whether they reflect necessary differences from risk assessment standards applicable outside the U.S.; and (2) whether the principles of the risk assessment process are articulated appropriately in the Proposed Standards and whether the direction provided in the Proposed Standards is clear and sufficient.[1] In addition, during the open meeting to approve the Proposed Standards for public comment, Board Member Goelzer indicated the Board may consider additional steps to promote transparency in the standard-setting process depending on the comments received.[2] Our overall comments below focus on these matters and present our most significant concerns about the Proposed Standards that we believe the Board should address.

First, we believe the PCAOB should further enhance its consideration of the ISAs in its standard-setting process, both specifically as it pertains to the Proposed Standards and on a going-forward basis. We recognize the efforts of the Board and its staff to reach a "degree of commonality" with the ISAs in the development of the Proposed Standards.[3] We strongly support the Board's expressed intention to "eliminate unnecessary differences between the Board's risk assessment standards and other risk assessment standards."[4] However, we do not believe that the Proposed Standards achieve this goal, as many unnecessary differences exist between the Proposed Standards and the ISAs. The benefits of converging audit standards are well recognized and supported by many, including certain members of the PCAOB,[5] the U.S. Government Accountability Office (GAO),[6] the CFA Institute,[7] as well as leaders in the financial community

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[1] PCAOB Release to the Proposed Standards (the "Release"), pp. 7 and 9. See also Appendix 9 of the Release, *Additional Discussion of Proposed Auditing Standards and Conforming Amendments.*

[2] Statement of Board Member Daniel L Goelzer on the Proposed Standards, October 21, 2008.

[3] See Release, page 8.

[4] Ibid.

[5] See, for example, Chairman Mark Olson's Remarks at FEE Conference on Audit Regulation Brussels (November 27, 2007) stating, "It makes sense to not only avoid creating unnecessary differences in auditing standards applicable to listed companies, but to work to bring them closer together." Also, PCAOB Board Member Bill Gradison's Remarks at Conference of the American Accounting Association Public Interest Section and the Academy of Accounting Historians (April 11, 2008), suggesting "that we move towards 'convergence' (or, if you prefer, 'harmonization') with International Standards of Auditing."

[6] See for example, GAO letter to the PCAOB on May 12, 2008 in response to the PCAOB's proposed Engagement Quality Review Standard and remarks of Jeffrey C. Steinhoff, Managing Director, Financial Management and Assurance, GAO, at the April 4, 2007 SEC Open Meeting, including his statement that, "[e]veryone will be best served by having standard setters develop consistent core auditing standards and, where there are any differences, to articulate why there is a difference or a need in the particular environment we're in. Inconsistencies in such core standards can increase audit costs and lead to potential confusion among management, users, and auditors."

[7] See the CFA Institute's official position, [i]t is in the best interests of investors and for global financial markets generally for the differing standards to be harmonized and complete convergence to be achieved at the earliest possible time. http://www.cfainstitute.org/centre/topics/reporting/official/harmonization_convergence.html

who helped develop the recommendations regarding *Sustaining New York's and the US' Global Financial Services Leadership* (the "Bloomberg/Schumer Report").[8] In order to achieve these benefits and eliminate unnecessary differences with other risk assessment standards, we recommend the Board establish a standard-setting process whereby it uses the language in the ISAs (which are developed with PCAOB input) as the starting point (i.e., the "base"), and then adds to or modifies it as the Board determines necessary for audits of U.S. public companies.

Second, we believe the PCAOB should make additional improvements to the structure, composition, and drafting of its standards in order to more clearly communicate its expectations of auditors, enhance the usability of the standards, and improve their application. It is imperative for auditors to have a clear understanding of the standards in order to be able to apply them. We believe the PCAOB could significantly improve the understanding and application of its standards by clearly communicating the objectives of an audit through the adoption of an overall audit objectives standard and by developing and using consistent drafting guidelines for its auditing standards.

Third, we believe it is critical for the PCAOB to improve the transparency of its standard-setting process. Transparency could be increased, for instance, by having more public dialogue and debate about draft standards, sharing draft standards with advisory task forces and/or the public prior to their issuance, and having a second exposure draft of proposed standards if significant comments are received. Greater transparency would provide greater opportunity for gaining valuable insights, promote the development of quality standards, and lead to a better understanding and application of the final standards.

These Overall Comments are discussed further below, along with illustrative examples to explain our concerns. Our Overall Comments were developed not only based on the request for comments as highlighted above, but also based on the general themes emanating from our detailed comments on the Proposed Standards, which are explained in the Exhibits as follows:

- Exhibit 1 to this letter contains detailed comments on each of the Proposed Standards and the Conforming Amendments. These comments are reflective of the impact of the process and approach in developing the Proposed Standards. In order to illustrate the relation between the detailed comments in Exhibit 1 to our Overall Comments, the detailed comments are provided in columnar format with a reference, where applicable, to the related Overall Comment(s).
- Exhibit 2 provides our answers to the questions posed by the PCAOB in Appendix 9 of the Release. To answer several of the questions we refer to comments provided in Exhibit 1.
- Exhibit 3 provides our editorial comments, which are not significant but should be considered and addressed.

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8 See Recommendation 5, which, in part, states, "…the PCAOB should work with other national and international bodies towards a single set of global audit standards." http://schumer.senate.gov/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf

II. Overall Comments

Like the Board, we believe these Proposed Standards have the potential to set the "foundation for future standard-setting."[9] As Board Member Goelzer described, "[a] sound and sophisticated understanding of the risks of material misstatement, and planning and executing an audit in a way that responds to those risks, are essential to affording investors reasonable assurance that financial statements are free of material error."[10] With the foundational importance of these Proposed Standards in mind, as well as the Board's request for comments on whether the Proposed Standards reflect "necessary differences from risk assessment standards applicable outside the United States," we provide the following comments.[11]

A. Convergence of Standards

1. The Board's consideration of the work by other standard setters is critically important in enhancing the effectiveness and efficiency with which standards are widely understood, implemented, and applied.

We strongly believe that the PCAOB should further enhance the convergence of its standard-setting activities with those of the International Audit and Assurance Standards Board (the "IAASB"), both in relation to the Proposed Standards and on a going-forward basis. The PCAOB's Strategic Plan outlines its intention to benefit from the work of other standard setters and professional bodies and to leverage best practices and other auditing enhancements made by the IAASB and the Auditing Standards Board (the "ASB"). We believe significant opportunities exist to more fully leverage standard-setting work that has been completed and is currently taking place. For example, the PCAOB currently attends and participates in IAASB meetings, thereby providing input to the IAASB standard-setting process. As such, we believe it would be appropriate and logical for the PCAOB, in developing its own standards, to use the ISAs as the starting point. For those specific areas where the Board believes different requirements are needed for purposes of conducting an audit of a U.S. public company, the Board should diverge from the ISAs and add to or modify the ISA language as appropriate. Such an approach is consistent with the PCAOB's Strategic Plan as discussed above. Furthermore, following the above standard-setting approach would create several benefits.

First, converging auditing standards may significantly improve the performance of audits around the world. A general understanding exists of the creation process for the ISAs and the rationale behind the adoption of certain provisions, primarily due to the transparency of the IAASB's process and its broad-based membership. Moreover, many firms develop their global audit methodologies based on the ISAs. Adding PCAOB requirements and guidance to an ISA base will improve the overall understanding by all parties around the world of what is expected by the PCAOB for audits performed for U.S. public companies. Additionally, such an approach may result in other countries (and the IAASB) adopting requirements similar to those added by the PCAOB, much like the replication by other countries to create auditor oversight bodies similar to the PCAOB. Creating audit standards in such a way that any "plus PCAOB" requirements are

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9 See Release, page 6.

10 Statement of Board Member Daniel L Goelzer on the Proposed Standards, October 21, 2008.

11 See Release, page 9.

obvious will make it easier for other countries (and the IAASB) to consider adding the same requirements.

Second, using the ISAs as a base would reduce confusion and misapplication of the standards in the U.S. It is much easier for auditors to understand, follow, implement, and apply one set of base standards (with specific additions for public company audits). The current process followed by the PCAOB to use different wording to explain the requirements and guidance for an audit is confusing. In many cases, the Proposed Standards are unclear as to whether the PCAOB is creating a different requirement or intends the same meaning, particularly when the Board seems to be referring to or explaining the same process or concept, but uses different words to do so.[12] Using different language significantly adds to the complexity of the standards, challenging auditors to interpret what exactly is required, which serves to adversely affect audit quality and efficiency (i.e., auditors will each independently and needlessly spend significant time attempting to interpret the standards' requirements, or may misinterpret the standards, and, as a result, may perform insufficient or inappropriate procedures). This confusion and complexity could grow exponentially as the PCAOB continues to issue new audit standards and revises its interim audit standards using the same approach as used in the Proposed Standards. Using the ISAs as a base will help avoid unintentional changes in practice, make the intentional changes obvious to all interested parties, and make comparability between the standards more apparent – all of which will help auditors apply the standards in practice.[13]

Third, having multiple sets of standards in the U.S. that use significantly different language, where the reasons for the differences are not clearly explained (and may be unintended), increases costs associated with educating, training, testing, and supervising auditors, and developing tools and methodologies, as well as standard-setting. In general, we believe standards should support the performance of both effective and cost-efficient audits. In this time of increased focus on costs, it is even more important to avoid duplication of efforts among standard-setters and to avoid creating obstacles to audit effectiveness and efficiency.

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[12] For example, Appendix 1, paragraph 3 states the following: "To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud." This guidance is in contrast to an equivalent paragraph in ISA 200, paragraph 17, which states the following: "To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion." It appears the PCAOB guidance is communicating the same information but using different language. It is not clear why the PCAOB Proposed Standard incorporates the "to form an appropriate basis" language and whether this language may in fact be intended to mean something other than obtaining reasonable assurance. If the PCAOB were using the ISAs as a base, paragraph 3 of Appendix 1 could state the following: "To obtain reasonable assurance, the auditor ***must*** obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion" (emphasis added to show changed words). Since it appears the PCAOB is communicating the same concept as that conveyed in ISA 200, paragraph 17, it appears appropriate in this instance to change only the "shall" to "must" to be consistent with PCAOB Rule 3101. By using this approach, it becomes clear that the PCAOB is conveying the same concept as what is in the ISA, and it is understandable to the reader why certain words need to be changed.

[13] We believe there could be many instances in the Proposed Standards where differences may have been unintentionally created. For instance, Appendix 4, Paragraph 4c states that, "[a]s part of the auditor's response to the risks of material misstatement due to fraud ("fraud risks"), the auditor should incorporate an element of unpredictability in the selection of auditing procedures…" In this paragraph, it appears the PCAOB is limiting the incorporation of elements of unpredictability to those areas identified as fraud risks. We do not believe this is the intention of the Board. We note that the language in this paragraph that refers to fraud is different than the language in the ISAs. (See ISA 330, paragraph A1).

For all of these reasons, we believe the Board should use the ISAs as the base for (1) the Proposed Standards, (2) updating its interim standards, and (3) developing new standards. We understand and accept that differences between PCAOB standards and the ISAs may be appropriate and needed; however, we also believe such differences should be clearly identified and understood by all parties. To facilitate this process, the PCAOB should continue to provide input as the ISAs are developed. When later developing its own versions of such standards, we recommend that the PCAOB commit to making changes only as needed to address issues particular to the audits of public companies in the U.S. In those instances where the Board decides to diverge from the ISAs, the Board should provide a clear and full explanation of the difference, the reason for the difference, and the intended outcome. Providing such information would improve the auditor's understanding of the Board's standards, the auditor's ability to apply the standards, and the transparency of the Board's standard-setting process.

We further encourage the PCAOB to consider how it may best leverage work that is currently being performed through the ASB standard-setting process, particularly as the PCAOB commences its process to review and update its interim standards. The ASB is in its first year of a three-year project to improve the clarity of its standards and converge them with recently approved clarified ISAs.[14] Through this process, all current ASB standards (Statements on Auditing Standards or SASs) will be updated using an ISA base, with modifications only (1) as needed to better serve the needs of U.S. users of audited financial statements for nonissuers or (2) as appropriate for U.S. legal and regulatory reasons. The PCAOB may find it very helpful to observe and participate in this clarity project. We are not suggesting the PCAOB's standard-setting mission and review of its interim standards be narrowed or limited, but rather that the PCAOB may effectively and more efficiently accomplish its mission by leveraging its efforts through collaboration with the ASB. For instance, PCAOB staff could attend ASB meetings, participate in the discussions as the ASB is continuing its clarity project, comment on draft ASB standards, and use those meetings to gain additional insights as to how best to update the PCAOB interim standards. The ASB, we believe, would be very open to hearing the views of the PCAOB, such input would add value to the ASB's deliberations, and would provide the opportunity for the PCAOB to influence the ASB standard-setting process (which may ultimately lead to fewer differences between PCAOB and ASB standards). Similarly, staff from the U.S. General Accounting Office attend and participate in ASB meetings, observe and participate in ASB task forces, and comment on ASB draft standards, thereby providing input throughout the ASB standard-setting process.

We would also support the idea of the PCAOB, IAASB, and ASB working together to "develop a road map for a systematic, joint, comprehensive standard-by-standard review, identifying and merging the highest quality aspects of each standard," as suggested by Board Member Gradison.[15]

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[14] See the *Auditing Standards Board International Convergence Plan* at the following link: http://www.aicpa.org/download/auditstd/ASB_Convergence_Plan.pdf and the ASB's Discussion Paper, *Improving the Clarity of ASB Standards.*

[15] See Board Member Gradison's Remarks to the Colorado Society of CPAs, December 19, 2008.

2. ***The Board should carefully consider the need for each requirement and balance such need with the ability to exercise auditor judgment based on principles and objectives.***

In its Release, the Board specifically seeks comment on how the Proposed Standards would change current practice and whether the Proposed Standards allow sufficient flexibility in the audit process.[16] We are concerned with how the Proposed Standards are drafted in light of PCAOB Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards* ("Rule 3101") and the impact of such drafting on auditor performance. We believe the manner in which the Proposed Standards are constructed result in additional required audit procedures, less emphasis on auditor judgment in performing such procedures, and less flexibility in the standards for the auditor to tailor procedures based on risk, size, and complexity of the company being audited, and additional audit documentation requirements. Irrespective of whether the PCAOB decides to use the ISAs as a base in developing its audit standards, we believe the Board should evaluate its application of Rule 3101 in the Proposed Standards.

Under the Board's Rule 3101, the auditor is required to fulfill specific responsibilities within an audit standard based on use of the words "must" or "should" (i.e., an "unconditional" or a "presumptively mandatory" responsibility, respectively).[17] In order for the auditor to demonstrate that he or she has fulfilled these responsibilities, and to comply with Auditing Standard No. 3, *Audit Documentation* (AS No. 3), he or she must have appropriate documentation within the working papers demonstrating what procedures were performed relative to each instance of a "must" or a "should." We noted that there are 218 instances within the Proposed Standards where either an unconditional or presumptively mandatory responsibility exists. We note that in many instances the PCAOB has elevated guidance and application material in the ISAs to presumptively mandatory requirements in the Proposed Standards. For example:

- Appendix 2, paragraph 17 states, "[t]he auditor should determine whether it is necessary to expand the planning activities to establish an appropriate audit strategy and audit plan, e.g., to determine the audit procedures necessary to obtain sufficient appropriate audit evidence regarding the opening balances," whereas this is application guidance in the ISAs (see paragraph A21 in ISA 300, *Planning an Audit of Financial Statements*).[18]
- Appendix 5, paragraph 11 includes a presumptively mandatory responsibility for the auditor to evaluate whether management's responses to unusual trends have been "vague." In contrast, Appendix 3 of ISA 240, *The Auditor's Responsibility to Consider*

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[16] See Release, page 6.

[17] PCAOB Rule 3101, sets forth three degrees of auditor responsibility based on the word usage in PCAOB audit standards as follows:

- *Unconditional Responsibility:* The words "must," "shall," and "is required" indicate unconditional responsibilities. The auditor must fulfill responsibilities of this type in all cases in which the circumstances exist to which the requirement applies.
- *Presumptively Mandatory Responsibility:* The word "should" indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type specified in the Board's standards unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard.
- *Responsibility to Consider:* The words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility to consider.

[18] All references to ISAs herein refer to the ISAs as redrafted through the IAASB's clarity project. Information about the IAASB's clarity project can be found at the following link: http://www.ifac.org/MediaCenter/?q=node/view/608.

Fraud in an Audit of Financial Statements, provides this as an example of applying the guidance.

Also, in many instances, the Proposed Standards introduce a presumptively mandatory responsibility followed by lists of procedures the auditor "should" perform. As a result, the amount of auditor effort necessary to address and document compliance with the presumptively mandatory responsibility vastly increases when we believe the overarching requirement could be addressed through a subset of the procedures in the list. In several cases, the long lists are elevated from application material in the ISAs, where they are presented as guidance on how the auditor may address the overarching requirement. For example:

- Appendix 3, paragraph 52 contains a significant number of detailed inquiries the auditor "should include" related to fraud risk, including creating a presumptively mandatory responsibility for the auditor to inquire of accounting and financial reporting personnel. (See further discussion of this paragraph in Exhibit 1.)

We are concerned that writing standards to create multiple presumptively mandatory responsibilities will significantly impact audit quality and how audit work is assessed by the PCAOB (through its inspection process) and others (e.g., in the litigation context). This approach to drafting standards will likely encourage a check-the box approach to auditing and place an undue focus on performing and documenting work to demonstrate compliance, rather than a thoughtful process whereby auditors design and apply audit procedures based on the assessed risks and the auditor's judgment in responding to those risks. We believe audit standards should allow for the application of judgment so that (1) the audit can be designed based on the facts and circumstances present; and (2) the auditor is not inhibited or discouraged from looking beyond prescribed lists of procedures to consider other procedures that may be necessary and appropriate. Such a principles-based approach to setting standards results in the performance of quality audits.

Further, we believe the PCAOB inspection process must be capable of operating under principles-based standards and of accepting auditors exercising professional judgment consistent with such principles-based standards. Otherwise, auditors will become reluctant to engage in the exercise of judgment that is so critical to the performance of an effective audit. Auditors make significant judgments about which areas of a company and its financial reporting pose the greatest risk, where audit resources should be allocated, and what procedures should be performed to address the identified risks. Seasoned judgment allows for audits to be conducted in an effective and efficient manner by focusing effort on the most significant areas, and where the greatest risk of misstatement lies. Unless the inspection process respects auditor judgment, auditors will become incentivized to follow the check-the-box approach described above. This clearly is contrary to the purpose of a risk-based audit approach, and the conduct of quality audits.

Based on the above, we recommend the Board consider whether, in each instance, it is necessary and appropriate to elevate guidance in the ISAs to a presumptively mandatory responsibility in the Proposed Standards, particularly in light of the reduced auditor flexibility and increased documentation requirements that result. In this same regard, we also recommend that the Board limit the use of "must" and "should" within the Proposed Standards to only the primary objectives, or the broad principles applicable to the risk assessment process, and that these primary principles be followed with example procedures for the auditor to consider. This will allow the auditor to plan and perform a more effective and efficient audit, without having to focus on performing a prescribed list of procedures and preparing documentation to demonstrate compliance with the repeated uses (218 occurrences) of these words, while at the same time providing sufficient and helpful guidance for the auditor to follow.

3. *The Board should use definitions and phrases in a manner consistent with other standard setters.*

Regardless of whether the PCAOB decides to use the ISAs as a starting point in developing its standards, the Board should use definitions and phrases consistent with the ISAs, unless the Board is intending a difference in the conduct of the audit. In the Proposed Standards certain definitions and phrases are different than those used in the ISAs, and it is not clear what result the different language is intended to achieve. For example:

- Appendix 1 includes a definition of risk of material misstatement that is different than the ISAs. (Please see further discussion regarding paragraph 5 of Appendix 1 in Exhibit 1.)
- In several instances, the word "determine" is used in the Proposed Standards whereas "establish" or "evaluate" is used in the corresponding ISA.
  - For example, Appendix 2, paragraph 6b states the auditor should "determine" compliance rather than "evaluate" compliance as is stated in ISA 300, paragraph 5b.
- The Proposed Standards use the phrase "significant account and disclosure" rather than "material class of transactions, account balance, and disclosure." (See, for example, Appendix 4, paragraph 40 in contrast to ISA 330, paragraph 20.)
- The Proposed Standards use the phrase "plan and perform the audit" rather than "design and perform audit procedures," which is used in the ISAs. (See for instance, Appendix 7, paragraph 4 in contrast to ISA 500, paragraph 6.)

We recommend, to avoid confusion among all parties and to avoid unnecessary implementation issues and costs, that the PCAOB use the same definitions and phrases as those used in the IAASB and ASB standards, unless the PCAOB is intending a change in auditor procedures. We also recommend, as discussed above, that when the Board determines a difference is appropriate, that it clarify the purpose of the difference, what the difference means, and what resultant change in auditor conduct is expected. Or, alternatively, if the Board intends the same meaning, but believes it is inappropriate to conform, it should be explained that certain definitions and phrases used by the PCAOB are intended to convey the same concept as those in the IAASB and ASB standards.

B. Drafting Conventions for Audit Standards (Including Content and Structure)

We believe it is very important for the Board to explain the fundamental concepts related to the performance of audits and to create guiding principles related to the development of PCAOB standards. Doing so will help clearly communicate the principles of the audit and expectations for auditors. To achieve this, we recommend the following.

1. Propose and adopt an overall audit objectives standard

In its Release, the Board sought comment on whether the fundamental principles of the audit process are appropriately articulated in the Proposed Standards.[19] While we agree that some of these fundamental principles are articulated, they are intermingled throughout the various standards, and some are missing, such as a discussion about reasonable assurance and limitations of an audit. We believe, in order to clearly articulate the fundamental principles of the audit, the PCAOB should propose and adopt a standard that explains the overall objectives of an audit.

Such a standard would:

- Establish the auditor's overall responsibility when conducting an audit;
- Set out the overall objectives of the auditor;
- Explain the nature and scope of the audit and the inherent limitations of an audit;
- Explain the scope, authority, and structure of the PCAOB standards, including language that denotes requirements;
- Include a discussion of the use of professional judgment;
- Explain how the objectives of each standard relate to the overall framework of PCAOB standards.

The lack of such a PCAOB standard makes it difficult to understand the basic principles critical to understanding the objective of the audit, the level of assurance an audit provides, and the responsibilities of an auditor under the PCAOB standards. For example, the Proposed Standards do not provide a definition of "sufficient appropriate audit evidence;" therefore, when this term is used, the full context of its meaning is not clear.[20] In contrast, the ISAs the concept of sufficient appropriate audit evidence is explained in ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*. To avoid any misunderstandings about the principle concepts related to an audit, we recommend that the PCAOB use the material in Appendix 1 of the Proposed Standards and ISA 200 to propose and adopt an overall audit objectives standard, in lieu of adopting Appendix 1 as proposed. We believe such an overall audit objectives standard is important to fully understand the Proposed Standards, and, as such, we recommend that such a standard be part of the consideration of these Proposed Standards.

2. Include clear objectives in all PCAOB standards

We support the inclusion of objectives in the Proposed Standards. Each objective should contain a statement of purpose of the standard. However, they should not contain "must" or "should" statements requiring auditor performance. The "must" and "should" statements should be reserved for the requirements within the standard that support the objective and lead to meeting the objective.

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[19] See Release, page 7.

[20] "Sufficient appropriate audit evidence" can be explained in its fullest context as follows: The auditor gathers sufficient appropriate audit evidence in order to reduce audit risk to an acceptably low level and thereby enables the auditor to draw reasonable conclusions on which to base the auditor's opinion and provide reasonable assurance.

We note that the previous six standards approved by the Board do not include objectives. Currently, it is not clear what the Board intends in terms of re-drafting prior standards to include objectives. We recommend the Board revisit these prior standards to include objectives. Additionally, we recommend the Board follow the practice of setting objectives in its consideration of future standards and in its review of the interim standards.

3. Enhance the integration of the audit by avoiding redundancy in the Proposed Standards

In its Release, the Board sought comment on enhancing the integration of the audit and the issue of whether incorporating aspects of AS No. 5 will help to improve the effectiveness and efficiency of the audit.[21] We believe the current partial integration and repetition of AS No. 5 and AU 316 in the Proposed Standards is confusing and will detract from the effectiveness and efficiency of the audit. With partial integration, the auditor may think he or she is looking at the entirety of the guidance, when in fact additional guidance resides in AS No. 5 and AU 316. This may result in the auditor not being aware that additional guidance is available and not reading or following that additional guidance. Also, repeated guidance may result in the auditor, upon seeing similar guidance, consulting other related standards to verify if the guidance is identical. Such needless exercise results in inefficiencies, and can be avoided simply by not repeating guidance.

Additionally, language throughout the Proposed Standards creates the impression that the auditor performs two separate risk assessments (when performing an integrated audit) and that the audit of internal control over financial reporting (ICFR) is separate from the audit of the financial statements. For instance, paragraph 1 of Appendix 1 refers to one risk assessment process for the financial statement audit and then states that AS No. 5 establishes requirements and provides direction regarding the auditor's consideration of risk in an audit of ICFR.

Based on the above, it is difficult to understand how these Proposed Standards will be integrated with the Board's other interim standards and with PCAOB Auditing Standards Nos. 1-6. Because of the repetition, it is not clear how the Proposed Standards will be codified in combination with existing standards. Without codification, the Board's standards will be difficult to follow.

Instead of repeating certain paragraphs in the Proposed Standards, we recommend that if guidance from AS No. 5 is equally relevant to an audit of the financial statements, it should be incorporated into the Proposed Standards and removed from AS No. 5 through a conforming amendment. In contrast, if there is guidance incorporated from AS No. 5 into the Proposed Standards that has no relevance unless the auditor is performing an integrated audit, we believe the guidance should remain in AS No. 5. For Example, Appendix 4, paragraphs 10, 14-17, 31-32, and 36 need not be repeated in the Proposed Standards; these paragraphs relate only to an audit of ICFR and would remain in AS No. 5. Additionally, to further enhance the integration of the audit, we recommend that AU 316 be fully incorporated into the Proposed Standards. Further, it should be made clear throughout the standards that when performing an integrated audit, the auditor performs one risk assessment process.

[21] See Release, page 7.

4. ***Consistently apply or revise PCAOB Rule 3101**, Certain Terms Used in Auditing and Related Professional Practice Standards*

The application of Rule 3101 in the Proposed Standards is not consistent with the language in Rule 3101. For instance, the Proposed Standards include the following phrases:

- The auditor "should take into account."
- For example, Appendix 4, paragraph 48 requires that "the auditor should take into account" certain matters in determining whether it is appropriate to perform substantive procedures at interim.
- The auditor "should not assume." (See comments on Appendix 3, paragraph 60 in Exhibit 1)

Since these phrases are not included or explained in Rule 3101, it is not clear how and whether the auditor would be expected to document or demonstrate compliance in these situations.

Additionally, in some cases, the present tense or the phrase "needs to be" is used in the Proposed Standards. Using the present tense and the phrase "needs to be" creates ambiguity and confusion as to what is required, as it is not clear how such phraseology fits into the Rule 3101 framework, and these statements are provided without explaining how the auditor's procedures should be performed. For example:

- Appendix 3, paragraph 11 states "Industry, regulatory, and other external factors that are relevant to the auditor's understanding…"
- Appendix 3, paragraph 12 states "Obtaining an understanding of the nature of the company includes obtaining an understanding of the following…"
- Appendix 4, paragraph 39 states that "the degree of reliance on controls needs to be reassessed…"
- Appendix 6, paragraph 5 states that "the materiality level for the financial statements as a whole needs to be expressed as a specified amount."

Moreover, a consistent rationale or a meaningful set of criteria is not apparent for making certain procedures requirements. For example, in Appendix 3, paragraphs 8-19 are written using various Rule 3101 word constructions; however, all of these paragraphs relate to how an auditor "should obtain an understanding of the company and its environment," which is the overarching presumptively mandatory responsibility in paragraph 8. For example, paragraph 13 states "the auditor *should consider* performing the following procedures…," paragraph 15 states "the following *are examples* of business risks that *might be relevant*," and paragraph 17 states "the following *examples...might affect.*" As the overarching presumptively mandatory responsibility exists in paragraph 8, one would expect consistent direction in achieving paragraph 8 in the paragraphs that follow; however, this is not the case. See further discussion of this comment in Exhibit 1.

Based on the foregoing, we recommend that the PCAOB reconsider Rule 3101, as it appears the application of Rule 3101 has become cumbersome and unwieldy in writing standards. Further, auditors may be applying the Rule 3101 levels of responsibility differently than intended by the Board. For example, perhaps it is not the intention of the Board to require the auditor to document the procedures performed and related results of all "should" statements. This is something the Board should consider in revisiting Rule 3101.

We also recommend the PCAOB consider using "shall" as it is defined and used in the ISAs for those matters that are to be requirements, instead of the must/should construction under Rule 3101. The *Preface to the International Standards on Quality Control, Auditing Review, Other Assurance and Related Services* explains that the word "shall" is used to express requirements and, further, that:

> The auditor complies with the requirements of an ISA in all cases where they are relevant in the circumstances of the audit. In exceptional circumstances, however, the auditor may judge it necessary to depart from a relevant requirement by performing alternative audit procedures to achieve the aim of that requirement. The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective. A requirement is not relevant only in the cases where: the ISA is not relevant; or the circumstances envisioned do not apply because the requirement is conditional and the condition does not exist. The auditor is not required to comply with a requirement that is not relevant in the circumstances of the audit; this does not constitute a departure from the requirement.[22]

As a result, the word "shall" in the ISAs is a stricter construction than use of the word "should" under Rule 3101; it is also different than the use of "must/shall" under Rule 3101. Adopting the use of "shall" as defined above would simplify PCAOBs standards, and would be consistent with the ISAs.

Additionally, we recommend the PCAOB develop a set of guidelines for using certain terms (such as "assess," "determine," "establish," "evaluate," etc.) and for using the present tense (for instance when providing a statement of fact), so that auditor performance requirements and expectations are clear. In applying such guidelines in the standard-setting process, the Board should consider the implications of the language chosen, including the resulting audit performance and documentation requirements, and consider whether the result will be an improvement in audit quality. Both the IAASB and ASB have put forth such drafting guidelines, which we believe would be helpful in this regard.

5. Follow a set order for all standards

We recommend that, in drafting standards, all requirements be explained first in the standard, followed by application guidance. Currently, requirements are spread throughout the Proposed Standards in paragraphs, notes, and appendices. As a result, it is more difficult for the auditor to find all of the required procedures and it is more difficult to assess whether all requirements are met. Placing the requirements first followed by additional guidance is the structure used by both the IAASB and the ASB in developing their clarified standards. Further, in adopting this structure the ASB has received very favorable comments from auditors, many of whom are small practitioners, to the effect that standards organized in this manner are much easier to understand, read, and apply.

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22 See *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services*, paragraphs 17-18. December 2006.

6. Modify the use of Notes and Appendices within the standards

The practice of using Notes in the Proposed Standards is confusing. The authority of Notes is not clear, and they are used for different purposes. In many cases, Notes contain presumptively mandatory responsibilities, and it is not clear whether this guidance is intended to be a part of the standard. For example, paragraph 21 of Appendix 3 contains a Note that states the auditor "should obtain an understanding of controls over the completeness and accuracy of that information…" Also, in some instances Notes contain references to other standards, but in other cases, similar references to other standards reside in the footnotes. For example, paragraph 42 of Appendix 4 contains a Note that refers to the Proposed Standard *Audit Evidence.* In contrast, paragraph 41 of Appendix 4 contains a Note with a footnote referring to AU sec. 350 *Audit Sampling*.

The practice of including certain guidance, including presumptively mandatory responsibilities, in Appendices is also confusing. For example, Appendix 3 of the Proposed Standards contains its own Appendix, and this Appendix includes presumptively mandatory requirements such as, "the auditor should obtain an understanding of how a company uses IT…" (see paragraph A1 of the Appendix to Appendix 3). Practitioners may not know how to apply this presumptively mandatory responsibility, as it is not clear what level of authority Appendices maintain within the PCAOB standards. Current PCAOB interim standards explain the following regarding Appendices:

> Interpretive publications consist of auditing Interpretations of the SASs, ***appendices to the SASs,*** auditing guidance included in AICPA Audit and Accounting Guides, and AICPA auditing Statements of Position. Interpretive publications are not auditing standards. Interpretive publications are recommendations on the application of the SASs in specific circumstances, including engagements for entities in specialized industries….The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.[23] (Emphasis added.)

So, while "should" statements are within Appendices to the Proposed Standards, some may view these matters as "interpretive publications" to be aware of rather than presumptively mandatory responsibilities.

Based on the above, we believe auditor responsibilities (as defined in Rule 3101) should not be presented in Notes, Appendices, or footnotes. We recommend that the PCAOB end the practice of using Notes, avoid using Appendices, and that all auditor requirements, presumptively mandatory requirements, and considerations be presented in numbered paragraphs within a standard.

7. Provide a glossary of terms

We recommend the Board follow a consistent approach with respect to defining terms. Some of the Proposed Standards (e.g., Appendix 3) define terms in a Definitions section. Other Proposed Standards define terms within the text of the standard (e.g., the definition of fraud risk in paragraph 4c of Appendix 4.) When the PCAOB adopted AS No. 5, however, a glossary of terms

[23] See PCAOB Interim Standards, AU 150.05 and 150.06.

was included in an Appendix. We recommend the PCAOB consistently define terms in a Definitions section of each standard, as appropriate, and create a Glossary with all defined terms.

8. Seek public comment on a reasonable effective date for the of Proposed Standards

We note that the Proposed Standards do not contain a proposed effective date. Prior to adopting an effective date, the Board should seek public comment on what would be a manageable implementation timetable. The amount of lead-time needed to implement a new audit standard depends upon the extent of changes in practice the standard will necessitate. However, it is most helpful (in terms of providing an adequate time frame to properly train our professionals and to modify methodologies and tools) if new standards become effective for audits of fiscal years beginning twelve months after the date the SEC approves the final standard.

C. Transparency and Public Involvement in the Standard-Setting Process

1. The PCAOB should improve the transparency of its standard-setting process to provide greater opportunity for gaining valuable insights, promote the development of quality standards, and lead to a better understanding and application of final standards.

The Board should increase the transparency of it standard-setting process, and develop practices to receive additional public input as standards are developed. This can be achieved, for example, by:

- Improving the visibility of Proposed Standards as they are being developed;
- Holding additional roundtables, providing detailed direct comparisons of proposed standards and new standards to current standards and to the ISAs;
- Re-exposing a revised standard after considering public comments prior to Board adoption;
- Using the SAG meetings as a vehicle to discuss comment letters and responses to the comments; and
- Having the Board more publicly debate the various issues when considering standards.

Further, the PCAOB could improve its transparency by establishing task forces of members with significant auditing expertise to deliberate standards at a level of detail that is not currently discussed at SAG meetings. Such detailed discussions would provide the Board with needed input and reactions from practitioners as to the implications, usability, and application of the standards, prior to their proposal.[24] Additionally, more visible and active participation by the PCAOB in the IAASB and ASB standard-setting process, including submitting comment letters, is yet another way for the PCAOB to be more transparent about its views and considerations, as the IAASB and ASB meetings are open to the public.

The Sarbanes-Oxley Act of 2002 (the "Act") and the Board's rules provide significant flexibility to the Board in determining the best way to establish professional standards and in using various means to accomplish its standard-setting objectives. Section 103 of the Act states:

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[24] If the PCAOB adopts the ISA base approach to its standard-setting process, these discussions could be focused on the areas where the PCAOB is considering diverging from the ISAs.

> …the Board shall, by rule, establish, including to the extent it determines appropriate, through adoption of standards proposed by 1 or more professional groups of accountants designated pursuant to paragraph (3)(A) or advisory groups convened pursuant to paragraph (4)…

Paragraph 4 of Section 103 of the Act states the following:

> The Board shall convene, or authorize its staff to convene, such expert advisory groups as may be appropriate, which may include practicing accountants and other experts, as well as representatives of other interested groups, subject to such rules as the Board may prescribe to prevent conflicts of interest, to make recommendations concerning the content (including proposed drafts) of auditing, quality control, ethics, independence, or other standards required to be established under this section.

Additionally, PCAOB Rule 3700 regarding Advisory Groups allows the Board to convene one or more advisory groups, in accordance with Section 103(a)(4) of the Act, to assist it in carrying out its responsibility to establish auditing and related professional practice standards. As a result, the Board may establish, at its discretion, ad hoc task forces to assist in the establishment of professional standards.

The Board should use the flexibility it has to enhance the input and feedback received throughout the standard-setting process. Neither the Act nor the Board's rules limit the means by which the PCAOB can make the standard-setting process transparent. The result will be improved quality, enhanced understanding, and improved application of the PCAOB standards.

III. Significant Detailed Comments

As discussed in the Introduction, our detailed comments on the Proposed Standards are described in Exhibit 1. Of the many detailed comments we have, the matters discussed below are of greatest concern. These matters are presented here in order to highlight those issues which, depending on how they are resolved, may have the most significant impact on the performance of an audit. The comments explained below are not repeated in Exhibit 1.

Appendix 3

- *Definition of significant risk.* The PCAOB's definition of significant risk in Appendix 3 is different than that of the ISAs. The proposed definition does not refer to "identified and assessed" risks, but rather only refers to "risks." The resulting implications are unclear. We believe the definition of significant risk should use the phrase "identified and assessed" risk. The concept of the auditor's risk assessment process is that the auditor identifies and then assesses significant risk, and then plans the audit procedures according to the "identified and assessed" risks. To remove these descriptors from the definition results in the auditor's risk assessment process becoming disconnected from the planned audit procedures and is contrary to the fundamental premise of the auditor's risk assessment forming the basis for the auditor's procedures.
- *Effect of fraud risk factors on the understanding of controls.* Appendix 3 provides guidance for the evaluation of controls over financial reporting, including topics that are highly dependent on the attitudes and actions of management, such as management's philosophy, style, integrity and risk assessment process (see paragraph 26). However, the Proposed Standards do not mention or require any consideration of the potential

management bias that may exist due to the existence of significant incentives/pressures, opportunities, or attitudes/rationalizations. These "fraud risk factors" are addressed elsewhere in the standard (see paragraph 58), but there is no guidance to consider how the presence of those factors could undermine the effectiveness of otherwise well-designed controls.

- *Management override*. The guidance provided in the Proposed Standards regarding the risk of management override is minimal. Appendix 3 makes passing references to management override (paragraphs 52, 62, 65); and Appendix 4 provides some guidance (see paragraphs 9-13). As a result, the Proposed Standards do not recognize the pervasive effect of this risk. We note that AU 316 contains guidance with respect to how to respond, but does not discuss how to assess the risk of management override.
- *Risk factors vs. fraud risk factors*. The promulgation of these standards creates an opportunity to develop an integrated list of risk factors. Appendix 3 refers to the existing list of fraud risk factors in AU 316. A review of that list reveals that many of the items are also indicators of potential errors. An integrated list could be set up in table form with columns for fraud and error, with checkmarks to indicate whether the factors could contribute to fraud, error, or both. A third type of risk could also be added — going concern risk — as many of the factors would contribute to that assessment as well. Such an integrated list would likely become a key part of an auditor's toolkit, as it would provide an integrated and efficient way of identifying potential risks.
- Based on the comments above regarding fraud risk factors and management override and those previously discussed in this letter, we recommend that AU 316 be incorporated in full with the Proposed Standards.

Appendix 4

- *The auditor's response to the risks of material misstatement.* The proposed objective of the Proposed Standards states, "the auditor is to address the risks of material misstatement through appropriate overall audit responses." This objective is disconnected with Appendix 3, which requires the auditor to identify and assess risks and then respond to those assessed risks. As a result, the Proposed Standard ignores the risk assessment process. The implication is that there is no purpose for performing the procedures required in Appendix 3. The PCAOB should make it clear in Appendix 4 that the objective of the auditor is to address the identified risks of material misstatement through appropriate overall audit responses and audit procedures.
- *Performing tests of details.* Paragraph 11 of Appendix 4 states that "the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the fraud risks." It appears that this language is creating a presumptively mandatory responsibility that tests of details should always be performed in response to identified fraud risks. We are not sure that this is the intent of the PCAOB, particularly as it is neither a requirement in the PCAOB's interim standards, nor in the ISAs to always respond to fraud risks in this manner. This paragraph, therefore, should be clarified and an illustration should be provided in order for auditors to understand what the PCAOB's intentions are and what change in audit practice (if any) is expected. As it is written now, this language may produce no change or many unintended changes. We believe the auditor, based on judgment, the risks identified, and the facts and

circumstances of the situation, should be able to decide whether to perform substantive analytical procedures or test of details in response to any identified risk and should not be limited to the types of procedures to perform.

- *Substantive procedures and sufficient appropriate audit evidence.* Paragraph 19 indicates that in certain situations substantive procedures alone cannot provide sufficient appropriate audit evidence, without explaining further when this might be the case. This is an important, but complex concept, and we therefore believe it should be more fully explained in the Proposed Standards. This can be accomplished by including the following guidance, excerpted from ISA 315, paragraph 29:
  - In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them.

<u>Exhibit 1: Specific Comments on Proposed Standards, by Paragraph</u>[25]

A. PCAOB Appendix 1 – Audit Risk in an Audit of Financial Statements	
Paragraph 2 – The following observations support our recommendation, as discussed in our Overall Comments, that the PCAOB should propose and adopt an overall audit objectives standard, rather than adopting this standard as proposed. In describing the objective of the auditor, paragraph 2 of Appendix 1 states, "The objective of the auditor is to conduct the audit of the financial statements in a manner that reduces audit risk to an appropriately low level." However, this objective relates to the overall objective of the auditor when performing an audit, and does not specifically relate to the title of this standard, *Audit Risk in an Audit of Financial Statements*. Further, the title of this Proposed Standard leads one to believe that audit risk, risk of material misstatement, and detection risk only relate to the audit of the financial statements, and not to an audit of ICFR, which is misleading. Additionally, we also note that while the topics included in this Proposed Standard relate to the overall audit, important concepts, guidance, and principles related to an audit on an overall basis are not included. For instance, a description of reasonable assurance and the inherent limitations of an audit are not included in this standard. For the reasons above and those articulated in our Overall Comments, we recommend the PCAOB use the material in Appendix 1 and ISA 200 to propose and adopt an overall audit objectives standard, in lieu of adopting Appendix 1 as proposed. We believe such an overall audit objectives standard is important to fully understand the Proposed Standards, and as such, we recommend that such a standard be part of the consideration of these Proposed Standards. In developing the overall audit objectives standard, we believe the objective ("reducing audit risk to an 'appropriately low level' ") and the description of reasonable assurance should align with ISA 200 and the exposure draft of the proposed SAS, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*. Currently, the objective in this Proposed Standard is different than the ISAs and the exposure drafts of the proposed SASs, which describe the objective of the auditor as reducing audit risk to an "*<u>acceptably</u>* low level" (emphasis added). Based on the information in the Proposed Standards and Release, it is not clear whether this is an intentional departure from ISA 200 and the exposure drafts of the proposed SAS, why such a departure is necessary, or whether the PCAOB, despite using different words, intends the objective of the auditor to be the same as for an audit conducted in accordance with the ISAs. According to Webster's Dictionary, the definition of acceptable is "satisfactory," whereas the definition of appropriate is	**Drafting Conventions & Convergence**

[25] As described previously, to illustrate the relation between the detailed comments in Exhibit 1 to our Overall Comments, the detailed comments are provided in columnar format with a reference, where applicable, to the related Overall Comment(s).

A. PCAOB Appendix 1 – Audit Risk in an Audit of Financial Statements	
"suitable for a particular person, place, etc.; proper or fitting." In the context of reducing risk in an audit, the concept of "acceptable" seems more suitable than "appropriate," which would appear to be more subjective and open to interpretation. We recommend that the PCAOB use the same words as the ISA to describe the objective of the auditor and the concept of reasonable assurance, unless the PCAOB intends the audits for U.S. public companies to have a different objective. If it is the case that the PCAOB is creating an intentional difference, this difference should be fully explained by describing (1) the reason therefor, (2) how the auditor's performance would be different, and (3) the intended outcome.	
Paragraph 5 – The Proposed Standard defines the risk of material misstatement as referring to "the risk that the financial statements are materially misstated due to error or fraud." This definition is in contrast to ISA 200 paragraph 13 and the exposure draft of the proposed SAS (*Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, paragraph 13), which describe the risk of material misstatement as "the risk that the financial statements are materially misstated *prior to the audit*" (emphasis added). Including the words "prior to the audit" makes it clear that the risk of material misstatement is the entity's risk, and not a function of the auditor's risk (which is affected by the auditor's actions or lack thereof). We recommend adding the words "prior to the audit" to the definition of risk of material misstatement.	**Convergence**
Paragraph 6 – The Proposed Standard does not sufficiently describe the types of risks of material misstatement at the financial statement level, how to identify such risks, and how to respond to such risks. In order to provide sufficient guidance to auditors regarding the risk assessment process (that is focused on identifying and responding to identified risks), we believe this Proposed Standard should include additional guidance similar to that included in ISA 315 paragraphs A98-A101 related to assessment of risks of material misstatement at the financial statement level.	**Drafting Conventions & Convergence**
Paragraphs 9 and 10 are inconsistent with each other and with paragraph 13 of Appendix 7. The first sentence in paragraph 10 implies that the auditor's ability to reduce detection risk is limited to the performance of substantive procedures alone, rather than all audit procedures. Paragraph 9 when describing detection risk refers to "procedures performed by the auditor" and to "audit procedures;" paragraph 13 of Appendix 7 states that audit procedures can be classified as falling into three categories: risk assessment procedures, tests of controls, and substantive procedures. As a result, the first sentence in paragraph 10, by only referring to substantive procedures, is confusing. We believe the concept of how to reduce	**Drafting Conventions**

A. PCAOB Appendix 1 – Audit Risk in an Audit of Financial Statements	
detection risk is sufficiently explained in paragraph 9. As such, the first sentence in paragraph 10 should be deleted.	

B. PCAOB Appendix 2 – Audit Planning and Supervision	
Paragraph 3 relates to the objective of the standard; however, we note this paragraph includes a "must" statement. We do not believe objectives should include "must" statements, as they should not establish requirements. See related recommendations in our Overall Comments. As such, we recommend deleting paragraph 3, as paragraph 2 sufficiently describes the objective of the auditor.	**Drafting Conventions**
Paragraph 6b states that the auditor should "determine compliance with independence and ethics requirements..." We recommend adding a footnote to this statement to clarify that determining compliance with independence rules can be achieved through a centralized process (i.e., that the auditor can rely on processes conducted by his or her firm in satisfying this requirement).	**Other**
Paragraph 7 repeats consideration points from AS No. 5, paragraph 9 (without referencing AS No. 5 and with a few wording differences), which we believe implies that these steps are performed separately for the financial statement audit and for the audit of ICFR. The consideration of the matters in paragraph 7 should be performed to provide the basis for planning both the audit of the financial statements and, if applicable, the audit of ICFR. Consequently, consistent with our recommendation in our Overall Comments, we think this guidance should be in the Proposed Standards and the duplicate paragraph removed from AS No. 5 through a conforming amendment. Additionally, the reference to "public information relevant to the evaluation of the likelihood of material financial statement misstatements…" is open-ended and could encompass wide-ranging information. We believe the auditor's consideration of public information should be limited to the information that comes to the auditor's attention.	**Drafting Conventions**
Paragraph 9b states that the auditor "should determine the significant factors that affect the direction of the engagement team." It is not clear what is meant by "affect direction" of the engagement team and how this differs or relates to item 9d, which refers to the "nature, timing, and extent of resources." The PCAOB should clarify what is meant. For instance, if the PCAOB is referring to directing the engagement team's efforts (as is described in similar guidance in ISA 300,	**Convergence & Drafting Conventions**

B. PCAOB Appendix 2 – Audit Planning and Supervision	
paragraph 7), we recommend this language be revised to be consistent with the ISA and state: "consider the factors that are significant in directing the engagement team's efforts."	
Paragraph 10b – Proposed Auditing Standard *The Auditor's Responses to the Risks of Material Misstatement* and Auditing Standard No. 5 include requirements to consider an assertion-level audit response. However, paragraph 10b does not specify the audit plan should include planned tests at the assertion level. We recommend paragraph 10b be revised to state "the planned nature, timing and extent of tests of controls and substantive procedures at the assertion level." This would be consistent with AS No. 5 and paragraph 8 of ISA 300.	**Convergence**
Paragraph 11 of the Appendix contains a requirement to determine the extent to which audit procedures are to be performed at selected locations in a multi-location entity. It is not clear how these multi-location considerations are different from (or the same as) those multi-location considerations related to the audit of ICFR (in Appendix B of AS No. 5). When performing an integrated audit, we believe the auditor should consider multi-location matters for purposes of a financial statement audit and an ICFR at the same time. The consideration of the matters in paragraph 11 should be performed to provide the basis for planning both the audit of the financial statements and, if applicable, the audit of ICFR. Consequently, consistent with our recommendation in our Overall Comments, we think this guidance should be in the Proposed Standards and the duplicate guidance removed from AS No. 5 through a conforming amendment. Additionally, a number of issues exist related to planning and performing multi-location audits. We believe these issues should be addressed in greater detail by the PCAOB, including consideration of ISA 600, *Special Considerations — Audit of Group Financial Statements (Including the Work of Component Auditors)*; however, we believe the other projects on the PCAOB's standard-setting agenda should have higher priority.	**Drafting Conventions & Convergence**
Paragraph 17 states that for an initial audit, the auditor should determine whether it is necessary to expand the planning activities; this is application material in the ISA. We question whether this needs to be elevated to a "should" presumptively mandatory responsibility, as we believe this is guidance with respect to achieving the requirements in paragraph 9. Moreover, this type of guidance (i.e., for initial audits) could be provided with respect to every aspect of the Proposed Standards, but we do not believe it is necessary. As such, we recommend revising this paragraph such that the auditor may consider whether it is necessary to expand the planning activities.	**Convergence**

B. PCAOB Appendix 2 – Audit Planning and Supervision	
Paragraphs 19-20 provide an example of using multiple "should" statements when it is not necessary, resulting in lack of flexibility and the creation of unnecessary documentation requirements. We believe paragraphs 19 and 20 are guidance to the requirements in paragraph 18, which states, "the engagement partner should supervise other engagement team members…" Paragraph 19 then states "Supervision should include the following" and then provides a list. Paragraph 20 continues and states that the level of supervision "should be appropriate for the circumstances…" Creating multiple "should" statements and imposing multiple requirements is not necessary. We believe the initial "should" statement in paragraph 18 is appropriate and sufficient. Therefore, we recommend that paragraphs 19 and 20 be revised to provide guidance on how to implement paragraph 18. For instance, paragraph 19 should be revised to begin with "Elements of supervision may include…" Paragraph 20 should be revised to state "the level of supervision of other engagement team members depends on many factors, including…" If the "shoulds" are not removed from paragraphs 19 and 20, the language should be changed to more clearly indicate what action the auditor is expected to perform that can then be documented. For instance, paragraph 20 as drafted states the level of supervision "should be appropriate…," which is not a direct action the auditor can undertake. The structure of paragraphs 18-20 can be contrasted with paragraph 14, which we believe provides a good example of how to structure guidance and direct the action expected of the auditor. The first sentence of paragraph 14 contains the "should" statement that is actionable. This is then followed by factors "that may be relevant to the auditor's determination."	**Drafting Conventions**
Paragraph 21 states that the partner and team members "should make themselves aware" of certain procedures to be followed when there are differences of opinion amongst the team. This phrase does not clearly set forth what the auditor is expected to do to satisfy this requirement, yet it is a presumptively mandatory responsibility that would also require documentation of how it has been achieved.	**Drafting Conventions**

C. PCAOB Appendix 3 – Identifying and Assessing Risks of Material Misstatement	
A significant portion of this Proposed Standard relates to obtaining an understanding of the entity and its environment. We note that the equivalent ISA standard (ISA 315) and the proposed equivalent SAS standard (AU 314) include this language in the title of the standard. We recommend the title of this Proposed Standard include a reference to obtaining an understanding of the entity and its environment. Because PCAOB interim standard AU 319, *Consideration of Internal Control in a Financial Statement Audit*, will be superseded, including such a reference in the title of the standard may help practitioners find the guidance related to gaining an understanding of the entity and its environment (including internal control).	**Drafting Conventions & Convergence**
Paragraph 3 – The objective for this standard states that "the auditor is to identify and appropriately assess the risks of material misstatement." This objective is different than ISA 315, which states "The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement." The intention behind this difference is not explained in Appendix 10. As a result, it is not clear if the Board has different expectations of the auditor in the context of this Proposed Standard. We think that the additional clarification in ISA 315 is helpful and provides direction as to the premise for and purpose of the auditor's risk assessment. Further, it is not clear what the PCAOB considers to be "appropriately" assessing the risks of material misstatement. We recommend using the objective in ISA 315, paragraph 3.	**Convergence**
Paragraph 5 states that "the auditor should perform risk assessment procedures to obtain sufficient appropriate audit evidence to identify and appropriately assess the risks of material misstatement due to error or fraud." However, the purpose of performing risk assessment procedures is *to identify and appropriately assess the risks* of material misstatement due to error or fraud, not "to obtain sufficient appropriate audit evidence." To obtain sufficient appropriate audit evidence requires the auditor to perform risk assessment procedures and other procedures that address the identified risks (including tests of controls and substantive tests). Footnote 2 explains this by stating, "risk assessment procedures by themselves do not provide sufficient appropriate audit evidence." The language in paragraph 5 contradicts footnote 2. We suggest the phrase "sufficient appropriate audit evidence" be deleted from paragraph 5.	**Drafting Conventions**

C. PCAOB Appendix 3 – Identifying and Assessing Risks of Material Misstatement	
Paragraphs 8-19 are written very differently, but all address how the auditor obtains an understanding of the company and its environment. Paragraph 8 sets up the presumptively mandatory requirement that "the auditor should obtain an understanding of the company and its environment…" However, this is then followed by inconsistent instructions to the auditor. For instance: o Paragraph 11 states certain factors "are relevant" (which is an example of using present tense, resulting in the question of whether or not this is imposing a requirement on the auditor). o Paragraph 12 states obtaining understanding "includes" certain matters. o Paragraph 13 states the "auditor should consider." (See further comments on this paragraph below.) o Paragraph 15 states certain examples "may be relevant." o Paragraph 17 states certain examples "might affect the risks of material misstatement." o Paragraph 19 states "the auditor should obtain an understanding." Because the presumptively mandatory responsibility is created in paragraph 8, each of the paragraphs that follow should provide additional guidance, not additional requirements. Such lists, as discussed in our Overall Comments, potentially result in audit inefficiency as a result of documenting how all of the matters have been addressed. As such, paragraphs 11-19 should provide elements or factors for the auditor to consider, rather than additional presumptively mandatory responsibilities. This would be consistent with ISA 315. We are also concerned with respect to the open-ended nature of the guidance in paragraph 13. It is not clear how an auditor can fulfill the responsibility of reading "public information;" this should be limited to information that comes to the auditor's attention. We also do not believe it is the responsibility of the auditor to observe or listen to live earnings calls; it is not the auditor's responsibility, nor should it be the auditor's responsibility to monitor or correct statements made during such calls. If the auditor is observing or listening this may likely create an inappropriate expectation of the auditor. We recommend this bullet be limited to reading transcripts. Further, it is not clear what would be sufficient in terms of the auditor "obtaining information about significant unusual developments regarding trading activity." For instance, is it expected that the auditor would obtain information about daily trade volumes and volatility or intra-day activity? We recommend the PCAOB be specific with respect to its expectations regarding the auditor's consideration of trading activity. Additionally, we note that paragraph 19 states "the auditor should obtain an understanding of the degree of transparency of the application of significant	**Drafting Conventions & Convergence**

C. PCAOB Appendix 3 – Identifying and Assessing Risks of Material Misstatement	
accounting principles and related financial reporting processes." This is not an actionable item for the auditor to achieve, as it is not clear what "degree of transparency" means as it pertains to application of accounting principles and financial reporting processes. We recommend deleting this bullet.	
Paragraphs 26 and 32 repeat information from AS No. 5. Additionally, paragraphs 20-33 are categorized as part of "Obtaining an Understanding of ICFR;" however, much of this is achieved through guidance in AS No. 5 related to "identifying entity-level controls" (see paragraphs 22-27 of AS No. 5). It is confusing to repeat information from AS No. 5 and to include procedures that are similar in both the Proposed Standards and in AS No. 5. It should be clear that when performing an integrated audit, the auditor obtains an understanding of internal control through a single process. Consequently, consistent with the recommendation in our Overall Comments, we think this guidance should be in the Proposed Standards and the duplicate paragraphs removed from AS No. 5 through a conforming amendment.	**Drafting Conventions**
Paragraph 34 – The Note to paragraph 34 is confusing because it implies that the auditor's identification of significant accounts and disclosures would be different in an audit of the financial statements, than for an audit of ICFR. This is not consistent with the concept of an integrated audit and with paragraph 7 of this Proposed Standard. The auditor's understanding of control activities should consider those control activities that are determined to be relevant in the context of the single set of accounts and disclosures that have been identified as significant to the integrated audit. The auditor's understanding of control activities, therefore, does not "encompass a broader range" of accounts and disclosures for purposes of the audit of ICFR as described in the Note to paragraph 34. We suggest that the PCAOB delete this Note.	**Drafting Conventions**
Paragraph 35 – Appendix 3 does not refer to the consideration of the internal audit function when obtaining an understanding of internal control. We believe it would be helpful to add a footnote to paragraph 35 that states the following (similar to ISA 315, paragraph A95): o In many entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities. AU 322, *The Auditor's Consideration of the Internal Audit Function*, establishes requirements and provides guidance on the auditor's consideration of the work of internal auditing. Management's monitoring activities may also include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.	**Convergence**

C. PCAOB Appendix 3 – Identifying and Assessing Risks of Material Misstatement	
Paragraph 38 states that "the auditor should *incorporate* knowledge obtained during past audits into the auditor's process for identifying risks of material misstatement" (emphasis added). This is not an actionable instruction that the auditor can carry out, as it is not clear what "incorporate" means or how the auditor would demonstrate compliance with this requirement. Moreover, we disagree with making this a "should" statement; rather, we believe this is something the auditor may consider doing. It is not clear what the desired outcome is of making this a presumptively mandatory requirement.	**Drafting Conventions**
Paragraph 41 – This paragraph states that the auditor should assess information obtained in "other engagements." The Note to this paragraph refers to "certain components audited by affiliated firms." As a result, the meaning of paragraph 41 is different from the ISAs. When referring to "other engagements" in ISA 315, paragraph 8, the intention of the IAASB was to refer to non-audit engagements, not procedures performed by affiliated firms for purposes of the audit. Other areas of the PCAOB standards, namely AS No. 3, address the information to be obtained in connection with audit procedures performed by affiliated firms. As such, we recommend deleting this Note. Also, the guidance in paragraph 41 should be limited to other engagements performed by the auditor for the entity. As the language is currently worded, it could be misunderstood to mean engagements for other clients. We do not believe this is the intention of the Board. As such, we recommend revising paragraph 41 to state the following: Where the auditor has performed other non-audit engagements for the entity, the auditor should consider whether information obtained in performing those other engagements is relevant to identifying risks of material misstatement.	**Convergence**
Paragraphs 42 and 44 – The language in paragraphs 42 and 44 seems to be describing substantive analytical procedures as opposed to preliminary analytical procedures, particularly in paragraph 44, which discusses developing expectations and comparing those expectations with recorded amounts. Without additional context, auditors may believe preliminary analytical procedures need the same degree of rigor as substantive analytical procedures, particularly since the existing guidance in PCAOB interim standards (in AU 329) regarding analytical procedures in planning the audit will be removed through the proposed Conforming Amendments. We do not believe it is the intent of the Board to require the same degree of rigor in analytical procedures for planning purposes as that required for substantive analytical procedures. This issue can be addressed by deleting the second sentence in paragraph 44 and adding the guidance included in paragraphs A7-A9 of ISA 315, which states the following:	**Convergence & Other**

C. PCAOB Appendix 3 – Identifying and Assessing Risks of Material Misstatement	
Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.	
Paragraph 49 states certain "matters should be emphasized." Additionally, the second bullet states all engagement team members "need to be alert." It is not clear how the auditor is expected to perform these procedures. Additionally, it is not clear how an auditor documents "placing emphasis" or being "alert."	**Drafting Conventions**
Paragraph 52 – Item d(1)-(4) creates a presumptively mandatory responsibility for the auditor to make inquiries of all accounting and financial reporting personnel regarding: o Views as to whether accounting policies were appropriately or aggressively applied; o Views as to the risks of fraud; o Knowledge of fraud, alleged fraud, or suspected fraud affecting the company; o Awareness of instances of management override of controls and the nature and circumstances of such overrides. Requiring inquiries of all personnel is onerous and does not allow for the application of professional judgment in carrying out these procedures. We note	**Convergence & Drafting Conventions**

C. PCAOB Appendix 3 – Identifying and Assessing Risks of Material Misstatement	
that paragraph 54 states "the auditor should assess who might reasonably be expected to have information..." It is confusing to create a presumptive mandatory responsibility in paragraph 52d and then seemingly modify this responsibility in paragraph 54. Because paragraph 50 provides the overarching requirement (that "the auditor should make inquiries of the audit committee, management, the internal audit function, and others within the company who might be expected to have information that is important to the identification and assessment of risks of material misstatement"), we recommend paragraph 52 be revised to include those matters the auditor may consider in conducting such inquiries. Such a construction would allow for greater use of auditor judgment, would be more consistent with principles-based standard setting, and would be consistent with ISA 240 and ISA 315.	
Paragraph 55 – This paragraph states that "the auditor should take into account that management is often in the best position to commit fraud…" This is not an actionable item for the auditor as it is not clear what "take into account" means. Paragraph 55 also states, "the auditor should obtain evidence to address inconsistencies in response to the inquiries." However, it is possible for management to provide incorrect information for which evidence cannot be obtained. As a result, the auditor may not be able to fulfill this presumptively mandatory responsibility, as the auditor may not be able to "obtain evidence to address the inconsistencies." Based on the above and in order to clearly communicate the expected auditor action, we recommend replacing paragraph 55 with the following guidance from paragraph A17 of ISA 240: "Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information. "	**Drafting Conventions & Convergence**
Paragraph 56c states that the auditor should "evaluate the types of potential misstatements…" We recommend that the PCAOB use the phrase "what could go wrong" rather than "the types of potential misstatements." Such language is consistent with paragraph 30 of AS No. 5 and paragraph 25c of ISA 315 and was also used by the Panel on Audit Effectiveness.[26]	**Convergence**

[26] *The Panel on Audit Effectiveness Report and Recommendations*, August 31, 2000, Recommendation 2.48 that the ASB "Require the auditor to make inherent risk assessments for significant account balances and classes of transactions by considering what could go wrong at the individual assertion level."

C. PCAOB Appendix 3 – Identifying and Assessing Risks of Material Misstatement	
Paragraph 60 states that "the auditor should not assume that all of the conditions discussed in the preceding paragraph must be observed or evident to conclude that a fraud risk exists." This is not an actionable procedure that the auditor can perform and document as it is not clear how an auditor "not assumes" and then documents that negative assumption.	**Drafting Conventions**
Paragraph 61 states that "the auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate the types of revenue or revenue transactions to which the risk relates." We agree with this statement. However, to appropriately respond to fraud risks and alter the nature, timing, and extent of procedures accordingly, we also believe that the auditor should evaluate which types of assertions give rise to such risks. Otherwise, the auditor may perform generic audit procedures across all types of revenue, rather than tailoring the procedures to the type of revenue and assertions involved. As described in the PCAOB's 4010 Report, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditor's Responsibilities With Respect to Fraud*, "The auditor should evaluate whether the fraud risk assessment can be linked to individual accounts or classes of transactions and related assertions. Linking in this manner assists the auditor in designing the appropriate audit procedures." As such, we recommend that the PCAOB add language similar to that in paragraph 26 of ISA 240, such that paragraph 61 states the following: The auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.	**Convergence**
Paragraphs 64 and 65 – It is confusing to see a repetition of guidance regarding the evaluation of controls, which is already discussed in paragraphs 20-36 of this standard. The PCAOB should make it clear why this guidance appears in these paragraphs, for instance by adding to the beginning of these paragraphs: "When the auditor has determined that a significant risk, including a fraud risk exists…"	**Drafting Conventions**
Appendix A – It is not clear why this guidance appears in an Appendix rather than the standard itself. Both paragraphs A1 and A4 contain presumptively mandatory responsibilities for the auditor. If the Appendix is intended to hold the same authority as the standard, it should be incorporated into the standard, particularly those paragraphs that contain "should" statements.	**Drafting Conventions**

D. PCAOB Appendix 4 – The Auditor's Response to the Risks of Material Misstatement	
Paragraph 4 states that "The auditor should design and implement overall responses to address the risks of material misstatement as follows" and then includes a list of those overall responses the auditor "should design and implement." One of these responses is "making general changes to the nature, timing, or extent of audit procedures." (See item e of paragraph 4.) It is then noted "the auditor should evaluate whether it is necessary to make general changes…" While we recognize the guidance in paragraph 4 is similar to that in ISA 330 paragraphs 5 and A1, it is important to point out that ISA paragraph 5 contains the requirement (i.e., "the auditor should design and implement overall responses to address the risks of material misstatement") and this is followed by guidance in paragraph A1, which states what the overall responses "may include" making "general changes." In contrast, paragraph 4 of Appendix 4 creates a presumptively mandatory responsibility of "making general changes," and this is followed by an explanation in item e that the auditor "should evaluate" whether changes are necessary. This construction, with multiple varying "should" statements, is confusing. Moreover, it is not clear how "making general changes" can be a presumptively mandatory responsibility. We recommend paragraph 4 be revised to state, "the auditor should design and implement overall responses to address the risks of misstatements," and be followed by overall responses that may be considered by the auditor (which would consist of items a through e in paragraph 4). It is also not clear how "general changes" in nature, timing, and extent in paragraph 4e are different from the changes in nature, timing, and extent discussed in paragraphs 6-8. We believe paragraphs 6-8 refer to changes at the assertion level. If this is the case, we recommend that the header prior to paragraph 6 be changed to "Responses to Material Misstatements at the Assertion Level." Further, in paragraph 4c it appears the PCAOB is limiting the incorporation of elements of unpredictability to those areas identified as fraud risks (as previously described in footnote 14 of our Overall Comments). We do not believe this is the intention of the Board. We note that the language in this paragraph that refers to fraud is different than the language in the ISAs. (See ISA 330, paragraph A1, which states, "Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.") We recommend deleting "due to fraud" from the second sentence in 4c.	**Convergence & Drafting Conventions**
Paragraph 5 – We note that this paragraph specifically refers to the application of professional skepticism and provides a definition of professional skepticism. Auditors apply professional skepticism throughout the audit, and, as a result, direct reference here seems to be limiting the application of professional skepticism to risks and not to the entire audit. We do not believe this is the intention of the Board. We recommend deleting this paragraph and instead	**Drafting Conventions**

D. PCAOB Appendix 4 – The Auditor's Response to the Risks of Material Misstatement	
including a discussion of professional skepticism in an overall audit objectives standard similar to ISA 200, as discussed further in our Overall Comments.	
Paragraph 7b and 9 – Paragraph 7b states the auditor "should take into account the types of potential misstatements…" The Note to paragraph 9 states, "the auditor should take into account those deficiencies when developing his or her response to fraud risks." Both of these paragraphs are creating a presumptively mandatory responsibility to "take into account" yet it is not clear what "take into account" means. As a result, it is not clear how the auditor fulfills these presumptively mandatory responsibilities and documents the procedures. As such, we recommend replacing "the auditor should take into account" with "the auditor should consider."	**Drafting Conventions**
Paragraphs 14-39 – The inclusion of this guidance, which is partially directed towards a financial statement audit (paragraphs 17-20), partially directed towards an internal control audit (paragraphs 14-16), and paragraphs that seem to apply in both a financial statement audit only and an integrated audit (paragraphs 21-39), is very confusing and difficult to follow. It is particularly confusing, as much of this guidance is already included in AS No. 5. As discussed in our Overall Comments, if AS No. 5 guidance relates solely to an integrated audit, it should remain in AS 5. If AS No. 5 guidance relates to both an integrated audit and an audit of the financial statements, then we recommend incorporating it into the Proposed Standards and removing it, through conforming amendments, from AS No. 5.	**Drafting Conventions**
Paragraph 18 – This paragraph discusses obtaining evidence that controls are effective during the entire period of intended reliance. AS No. 5, paragraph B4 provides additional guidance regarding obtaining evidence that the controls operated effectively during the entire period. If the PCAOB agrees the guidance in AS No. 5, paragraph B4 relates to both an integrated audit and an audit of the financial statements, then we recommend incorporating it into the Proposed Standards and removing it, through conforming amendments, from AS No. 5.	**Drafting Conventions**

D. PCAOB Appendix 4 – The Auditor's Response to the Risks of Material Misstatement	
Paragraph 19 – Assessing completeness and accuracy of financial information is limited in this paragraph to information used in performing substantive analytical procedures; however, the auditor may need to test completeness and accuracy of data when performing other types of procedures, including tests of details. As such, this paragraph should be revised accordingly or an additional paragraph could be created to address the concept of testing the completeness and accuracy of data (as this is a separate concept from that in the first part of the sentence related to areas where substantive testing alone cannot provide sufficient appropriate audit evidence).	**Other**
Paragraph 37 – The text of paragraph 37 appropriately states, "when controls have been tested in past audits, the auditor should take into account the following factors to determine the evidence needed in the current year audit to support the auditor's control risk assessment." However, the discussion in Appendix 10 states that "the proposed standard required auditors to obtain evidence about controls selected for testing each year" and contrasts this to ISA 330, which allows the auditor to use evidence from prior audits about operating effectiveness of controls without retesting, subject to certain conditions and limitations set forth in the audit. We believe that for financial statement audits it is appropriate for the auditor to, based on the facts and circumstances, evaluate the length of the time period that may elapse before retesting the operating effectiveness of a control and not test the operating effectiveness of every control each year, and we believe paragraph 37 as drafted permits this. If the PCAOB intends to require auditors to test the operating effectiveness of each relevant control every year when performing a financial statement audit, this will be a significant change in current practice, and one we do not believe to be necessary.	**Convergence**
Paragraph 38 – The Proposed Standard continues to use the term "control risk." Both the ISAs and the SASs are no longer using this term. We recommend that the PCAOB not use this term, as we believe it is not necessary and will cause confusion. Continuation of this term in the PCAOB standards could indicate a conceptual difference, when one is not intended. As such, we recommend that inherent risk and control risk not be referred to separately, but rather referred to as a combined assessment of the "risks material misstatement."	**Convergence**
Paragraph 41 – The last sentence of the Note to this paragraph states "Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the *<u>assertion and the effectiveness of the control</u>*" (emphasis added). However, when discussing dual-purpose tests, this Note should discuss forming a conclusion about the "*<u>substantive test</u>* and effectiveness of	**Other**

D. PCAOB Appendix 4 – The Auditor's Response to the Risks of Material Misstatement	
control" (not the "*assertion* and the effectiveness of the control") as this is the purpose of a dual-purpose test. Additionally, this note creates requirements for designing and evaluating dual-purpose tests. We do not believe these need to be presumptively mandatory responsibilities, but rather can be drafted as guidance.	
Paragraph 45 – See comments (in the Significant Detailed Comments on page 19) related to performing tests of details for significant risks as explained in relation to paragraph 11 of this Proposed Standard.	**Other**
Paragraph 48 states that "the auditor should take into account" certain matters when determining whether it is appropriate to perform substantive procedures at an interim date. This is not an actionable instruction that the auditor can perform and document, as it is not clear what "take into account" means.	**Drafting Conventions**

E. PCAOB Appendix 5 – Evaluating Audit Results	
Paragraph 3b proposes a definition of misstatement. However, the first sentence actually defines a material misstatement. While the first sentence is a factual and accurate statement, it does not belong in the definition of misstatement. We suggest deleting the first sentence of 3b. Additionally, in the second sentence of 3b, the PCAOB says a misstatement "may relate to" a difference. ISA 450 explains that a misstatement is a difference. It is not clear what the intention is of using "may relate to." We suggest replacing the words "may relate to" with "is."	**Convergence**

E. PCAOB Appendix 5 – Evaluating Audit Results	
Paragraph 8 – This paragraph states, "the nature, timing, and extent of the analytical procedures that should be performed during the overall review depend on the nature of the company and its industry." Analytical procedures performed in the final stages of the audit are similar to the analytical procedures performed during risk assessment. To make this point clear, ISA 520, paragraph A19 states that such analytical procedures"…may be similar to those that would be used as risk assessment procedures." We recommend the PCAOB add such clarification to paragraph 8. Without such clarification, the requirement in paragraph 8 may lead to inconsistency in practice; particularly, the performance of substantive analytical procedures that are not necessary to achieve the aim of the requirements in paragraphs 6 and 7.	**Convergence**
Paragraph 11 states that the auditor "*should evaluate* " inconsistent responses from management, whereas ISA 240, paragraph 14, and the exposure draft of the proposed AU 316, paragraph 14 states the auditor "*shall investigate* " such inconsistencies (we also note that the existing PCAOB interim standard uses the phrase "*should consider*"). "Should evaluate" could be interpreted as being a different requirement. Drafting guidelines for ASB standards provide that "investigate" is used only when follow-up procedures are required to more thoroughly look into a matter once suspicions have arisen, whereas "evaluate" directs the auditor to identify and analyze the relevant issues. The PCAOB should clarify the intent of using the words "should evaluate," and if a difference is not intended, use the same language as the ISA. Additionally, although we recognize AU 316.68 currently references "vague responses," we believe the meaning of "vague responses" is unclear. As currently used in the interim standards, "vague" it is in the context of "a condition that may be identified" rather than a presumptively mandatory responsibility. We recommend replacing "vague" with "imprecise or not at a sufficient level of detail to be useful," as we believe this is the intended meaning of "vague" in the current guidance.	**Convergence & Drafting Conventions**
Paragraph 14 of the Appendix describes three categories of misstatements, but uses terms that are inconsistent with ISA 450, even though the descriptions of the terms seem to be the same. The Proposed Standard uses the terms "specifically identified misstatements, projected misstatements from substantive audit sampling, and misstatements related to accounting estimates that are outside of a reasonable range." Whereas the ISAs use the terms "factual misstatements, judgmental misstatements, and projected misstatements." We have several concerns with the terms in the Proposed Standard as follows: o Using the term "specifically identified" is confusing, as one could argue	**Convergence**

E. PCAOB Appendix 5 – Evaluating Audit Results	
that all misstatements are "specifically identified." We suggest the PCAOB use the term "factual misstatement" rather than "specifically identified." o The PCAOB's reference to "misstatements related to accounting estimates that are <u>*outside of a reasonable range*</u>" seems to equate to the ISA term "judgmental misstatements" (emphasis added). However, we believe the PCAOB's description is too narrow, as misstatements related to accounting estimates might not "be outside of a reasonable range," but rather may relate to a misstatement of a point estimate. o Additionally, the terminology in the Proposed Standard does not seem to recognize judgmental misstatements related to "the selection or application of accounting policies that the auditor considers inappropriate." We suggest that the PCAOB, rather than using the term "misstatements related to accounting estimates that are outside of a reasonable range," use the term "judgmental misstatements" and describe these as differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.	
Paragraph 15 – The Note to this paragraph states that detection risk will "<u>*likely be*</u>" unacceptably high if misstatements approach materiality, whereas ISA 450, paragraph A5 says it "<u>*may be*</u>." "Likely be" could be interpreted as being stronger than "may be." It is not clear if the Board is intentionally diverging from the ISA and what the expected difference in auditor performance is.	**Convergence**
Paragraph 16 requires the auditor to communicate accumulated misstatements to management, but does not require the auditor to request management to correct the misstatements as in ISA 450, paragraph 8. The PCAOB standard should include this requirement and conform to the ISA.	**Convergence**
Paragraphs 18 and 19 – The PCAOB standard splits the requirements relating to the evaluation of uncorrected misstatements into two separate paragraphs, whereas these concepts are combined into one paragraph in ISA 450 (see paragraph 11). By splitting the requirement, the Proposed Standard has lost the connection between these two paragraphs and why the procedures in paragraph 19 are being performed. We suggest combining paragraphs 18 and 19. Also, paragraph 18 includes a Note that states, "If the financial statements contain material misstatements, the auditor <u>*should*</u> issue a qualified or an adverse opinion	**Convergence & Drafting Conventions**

E. PCAOB Appendix 5 – Evaluating Audit Results	
on the financial statements" (emphasis added). While this is a factual statement, this concept is included in the reporting standards, and it is not necessary to repeat this guidance within this Proposed Standard. Additionally, within paragraph 19, the PCAOB uses the words "*detected*" in prior years instead of "*related*" to prior years as used in ISA 450, paragraph 11. This changes the meaning of the guidance since there may be misstatements detected in the current year and related to the prior year (which would be encompassed in the ISA language, but not the PCAOB language). We recommend "detected in" be changed to "related to."	
The second sentence of paragraph 20 requires the auditor to evaluate the effect of *all* accumulated misstatements on the assessed risk of material misstatement, whereas the ISA 330, paragraph A57 notes this evaluation should be done on *individual* misstatements, which we believe is appropriate. The Proposed Standards should conform to the ISA language and refer to the evaluation of individual misstatements.	**Convergence**
Paragraph 26 begins by referring to "examples" of forms of management bias, but then makes the auditor's evaluation of such examples a presumptively mandatory requirement. This paragraph should be revised to clearly state the actions expected of the auditor, perhaps by first articulating the responsibility, then providing examples. Additionally, a-c of paragraph 26 are meant to provide examples of "bias." However, examples b and c use the word "bias;" as a result, the example of "bias" is "bias." These examples should be amended to provide more descriptive examples of bias, without using the word "bias."	**Drafting Conventions**
Paragraph 28, which discusses what to do when there is a difference between management's estimate and the auditor's estimate, attempts to combine two separate concepts — the use of a point estimate and the use of a range in evaluating management's estimate. By doing so, it is not clear how the auditor determines the amount of the misstatement in these different circumstances. The guidance in paragraph 28 should mirror ISA 540, paragraph A116, which separately discusses point estimates and ranges in evaluating management's estimate. As such, paragraph 28 should be revised to include the following guidance: o Where the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement.	**Convergence**

E. PCAOB Appendix 5 – Evaluating Audit Results	
o Where the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range. Further, paragraph 28 does not discuss "bias," which is indicated in the heading to this paragraph "Assessing Bias in Accounting Estimates." As such, perhaps this guidance should be located elsewhere in the Proposed Standard, for instance in the section "Accumulating and Evaluating Identified Misstatements." This guidance should apply regardless of whether bias exists.	
Appendix 5, Paragraph 32 – This paragraph seems to be inappropriately included in this Proposed Standard. Paragraph 30 of this Proposed Standard already addresses the requirement to evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of fraud risks and the need to modify the audit procedures to respond to those risks. We recommend moving paragraph 32 to Appendix 3, *Identifying and Assessing Risks of Material Misstatement*, and that a footnote reference to Appendix 3 be added to paragraph 30 of Appendix 5. We also suggest replacing the phrase "earlier in the audit" in paragraph 30 with the phrase "throughout the audit," as fraud risks are considered throughout the audit.	**Drafting Conventions**
Paragraph 35 provides the requirement for the auditor to conclude whether sufficient appropriate audit evidence has been obtained to support the opinion. Paragraph 36 then lists factors relevant to this conclusion, but does so by using the present tense in stating "Factors that are relevant to the conclusion…include the following…" As currently drafted, paragraph 36 is creating an implied requirement to consider the factors. We recommend revising paragraph 36 to state, "When concluding on whether sufficient appropriate audit evidence has been obtained, the auditor may consider the following factors…"	**Drafting Conventions**
Paragraphs 39 and 40 limit the implications of deficiencies on the risk assessments and overall evaluation of the financial statements to integrated audits. However, these procedures would pertain to a financial statement audit, not just an integrated audit. Additionally, these paragraphs are taken directly from AS No. 5 (see paragraphs B5 and B6). As discussed previously, we do not believe guidance should be repeated. Since this guidance equally relates to an integrated audit and an audit of the financial statements only, we recommend this guidance remain in the Proposed Standard, and be removed from AS No. 5 through a conforming amendment.	**Drafting Conventions**

E. PCAOB Appendix 5 – Evaluating Audit Results	
Paragraphs 41-44 are also taken directly from AS No. 5. As discussed previously, we do not believe guidance should be repeated. Consistent with our Overall Comments, because this guidance relates solely to an integrated audit, we recommend this guidance remain solely in AS No. 5.	**Drafting Conventions**
Paragraph A1 of Appendix A includes a requirement for the auditor to determine whether the assessment of fraud risks needs to be reassessed. This requirement should not be included in the Appendix, as it is already addressed in paragraph 32. Additionally, as discussed in our Overall Comments, it is not clear why certain guidance exists in an Appendix or what level of authority the Appendix holds. If the Appendix is intended to hold the same authority as the Proposed Standard, it should be incorporated into the standard.	**Drafting Conventions**

F. PCAOB Appendix 6 – Consideration of Materiality in Planning and Performing an Audit	
Paragraph 3 – In the Note to this paragraph, the PCAOB states "it *ordinarily* is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors." This implies that there are instances when it would be practical to design such audit procedures. We disagree with this notion. Additionally, the first sentence of the Note states the auditor should be "alert" for misstatements; this is not actionable by the auditor. It is not clear how an auditor can perform or document being "alert." Based on the above, we suggest this Note be deleted.	**Other & Drafting Conventions**
Paragraphs 8 and 9 use the term "tolerable misstatement" to explain what we believe is the concept of "performance materiality" as used in the related ISA (see ISA 320, paragraph 11) and exposure draft of the related proposed SAS (See proposed AU 312, paragraph 11). Using the words "tolerable misstatement" to describe what is defined as "performance materiality" in the ISAs will cause confusion. The term "tolerable misstatement" in the ISAs is the *application* of performance materiality to a particular sampling procedure, and may be the same amount or an amount lower than performance materiality. "Performance materiality," however, is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for	**Convergence**

F. PCAOB Appendix 6 – Consideration of Materiality in Planning and Performing an Audit	
the financial statements as a whole. To avoid confusion, we suggest the PCAOB use the term "performance materiality" in paragraphs 8 and 9. Additionally, the PCAOB should maintain the use of the term "tolerable misstatement" in AU 350, as this term specifically relates to sampling. Incorporating both the concepts of performance materiality and tolerable misstatement (as used in the ISAs) in the PCAOB standards will be helpful to auditors.	
Paragraph 9 uses the phrase "the auditor *should take into account.*" It is not clear what this means. For instance, it is not clear if this is the same as "the auditor should consider" or if the PCAOB intended a different auditor action. We recommend changing "should take into account" to "should consider."	**Drafting Conventions**
Paragraph 10 states that the auditor should "*reassess*" the established materiality, whereas ISA 320, paragraph 12 says the auditor shall "*revise*" materiality. To "reassess" may be interpreted as being a weaker audit procedure because it might not drive the auditor to make changes; as opposed to "revise" which implies that a change is required (which would be appropriate in situations 1 and 2 included in this paragraph.) Therefore, we recommend the PCAOB use the word "revise" instead of "reassess."	**Convergence**
Paragraph 11 includes a Note that the reassessment of materiality and tolerable misstatement "*is also relevant*" to the evaluation of identified misstatements. Paragraph 10 of ISA 450 states this as an auditor requirement, that the auditor "shall reassess" materiality prior to the evaluation of misstatements. We recommend making this a "should" statement and including it before paragraph 18 of Appendix 5 (which relates to the evaluation of uncorrected misstatements).	**Convergence**

G. PCAOB Appendix 7 – Audit Evidence	
Paragraph 2 – This paragraph describes audit evidence and seems to be describing the same concept as that conveyed in the ISAs; however, this paragraph contains different language than what is included in ISA 500, paragraph 5c. Paragraph 2 defines audit evidence as "all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the audit opinion is based. Audit evidence consists of both	**Convergence**

G. PCAOB Appendix 7 – Audit Evidence	
information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and any information that contradicts such assertions." ISA 500, paragraph 5c defines audit evidence as "Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information." To avoid confusion and unnecessary differences in terminology, we recommend that the PCAOB use the ISA language to describe audit evidence. If the PCAOB intends to create a different definition of audit evidence, this difference should be clearly described and explained.	
Paragraph 3 – The proposed objective of this Proposed Standard is overly broad as it relates to the entire audit. The focus of this Proposed Standard, however, is how to design and perform audit procedures to obtain sufficient appropriate audit evidence, and this should be the focus of the objective of the standard. As such, we recommend that paragraph 3 be replaced with language in paragraph 4 of ISA 500, which describes the auditor's objective as the following: "the objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion." We believe it is unnecessary to diverge from the ISA on the objective of audit evidence, as this should be a universal concept.	**Convergence**
Paragraph 6 states that audit evidence ***must*** be relevant and reliable. This sentence is creating an unconditional responsibility under PCAOB Rule 3101; however, this is not an action-oriented statement that can be implemented by the auditor. Additionally, this paragraph (and those that define relevance and reliability) does not seem to acknowledge that there are degrees of relevance and reliability, which is recognized in paragraph 5 of the Proposed Standard. As such, we recommend that the word "must" be removed from paragraph 6 and that it be revised as the follows: Appropriateness is the measure of the quality of audit evidence (i.e., its relevance and reliability). When designing and performing audit procedures, the auditor should consider the relevance and reliability of the information to be used. This would be consistent with ISA 500, paragraphs 5 and 7.	**Convergence & Drafting Conventions**
Paragraph 12 – The structure of paragraph 12 implies that different assertions exist for a financial statement audit and an integrated audit, as it seems to imply that different assertions may exist if you did (b) as opposed to (a). This is confusing. We believe that the reason for the auditor to base his or her work on different	**Drafting Conventions**

G. PCAOB Appendix 7 – Audit Evidence	
assertions would be the same under either a financial statement audit only or an integrated audit. This paragraph should be revised to make this clear.	
This Proposed Standard is silent on use of evidence from previous audits and the auditor's cumulative knowledge for purposes of supporting the auditor's risk assessment. ISA 500 application material acknowledges that information from previous audits and the auditor's cumulative knowledge may be used and included as audit evidence, provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit. See paragraphs A1, A11, and A26 of ISA 500. The PCAOB should acknowledge that information from previous audits may be used as possible audit evidence.	**Convergence**
Paragraph 27 – The Proposed Standard does not acknowledge that "selective examination of specific items, particularly if those items are selected based on the auditor's belief that they are more likely to contain a misstatement, may provide the auditor with some audit evidence concerning the remainder of the population" as is described in the exposure draft of proposed AU 318, paragraph A26. As a result, it is not clear that if the items tested are wrong, there may be implications on the rest of the items. We recommend this language be added to the Proposed Standard.	**Convergence**

H. PCAOB Appendix 8 – Conforming Amendments	
As we have previously recommended, when proposing and making Conforming Amendments to the interim standards, the PCAOB should provide a full mark-up of the proposed changes to the interim standards.[27] We understand that perhaps the PCAOB does not wish to add to the length of its proposals; however, if this is a concern, the PCAOB could post such mark-ups to its Web site, so that they are available for all interested parties. Such mark-ups of the interim standards should show both deleted and new text and should be provided at the time of the exposure draft, at the time the standard is approved by the Board, and at the time the standard is approved by the SEC (if further changes are made). Providing such mark-ups enhances the auditor's understanding of the proposed and final changes being made and the related effects. Such information also facilitates efficient and effective implementation of a new standard because the auditor, by reading a	**Drafting Conventions**

[27] See D&T comment letter to the PCAOB on its Proposed Auditing Standard – *Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards* [PCAOB Release No. 2007-003; PCAOB Rulemaking Docket Matter No. 23], May 18, 2007.

H. PCAOB Appendix 8 – Conforming Amendments	
mark-up, can more easily identify and understand the changes being made to current standards and practice. Additionally, providing such information at the time a standard is proposed will facilitate a more effective comment process as potential practice issues might be more readily identified and, therefore, raised through the comment process. As such, the Board and its staff would have an opportunity to address such issues at the front-end of the standard setting process rather than on the back-end by, for example, having to issue staff questions and answers to resolve implementation issues.	
AU 316.30 of the PCAOB interim standards, which discusses analytical procedures performed for planning purposes generally using data at a high level, would be deleted through the proposed Conforming Amendments. This guidance is not included in the Proposed Standard, *Identifying and Assessing Risks of Material Misstatement*. We recommend this paragraph be added to this Proposed Standard (in the section that discusses performing analytical procedures, Appendix 3, paragraphs 42-44) to remove any indication that the analytical procedures described in this Proposed Standard are substantive analytical procedures. See additional comments regarding paragraphs 42-44 of Appendix 3.	**Other**
AU 316.49 – The Conforming Amendments propose to remove the guidance regarding withdrawing from an engagement if it is not practicable to design procedures that sufficiently address the risks of material misstatement due to fraud. We recommend that this paragraph (AU 316.49) be retained either in AU 316 (or in the Proposed Standards if AU 316 is incorporated in full into the Proposed Standards).	**Other**
AU 316.77 – The proposed Conforming Amendments would delete items c and d in paragraph 77; however, this guidance is not included in the Proposed Standards. These items include guidance regarding situations when the auditor believes a misstatement is a result of fraud and directs the auditor to (1) discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and the audit committee and (2) if appropriate, suggest that the client consult with legal counsel. We believe this guidance is very important and recommend keeping this guidance either in AU 316 or in the Proposed Standards.	**Other**

H. PCAOB Appendix 8 – Conforming Amendments	
AU 316.78 – The proposed Conforming Amendments would delete the guidance in AU 316.78 (which relates to withdrawing from an engagement when significant risks of fraud exist), but no equivalent guidance appears to be in the Proposed Standards. This is important guidance. We recommend retaining the paragraph in AU 316 or in the Proposed Standards.	**Other**
AU 350.48 – We recommend adding back the last sentence of item 2 of paragraph .48, which states "However, the second standard of field work contemplates that ordinarily the assessed level of control risk cannot be sufficiently low to eliminate the need to perform any substantive tests to restrict detection risk for all of the assertions relevant to significant account balances or transactions classes." We believe this is helpful guidance.	**Other**
AU 9350 – The proposed Conforming Amendments would delete the guidance in AU 9350. As the concepts included in AU 9350 are not included in the Proposed Standards, we recommend adding the interpretation back to the section.	**Other**

I. PCAOB Appendix 10 – Comparison of Requirements to the Standards of the IAASB	
While we appreciate and commend the Board for providing a high-level comparison between these Proposed Standards and the comparable ISAs in Appendix 10, this comparison is not sufficient. Many of the firms' methodologies are based on the ISAs or on GAAS. As such, in order to effectively and efficiently understand and implement the Board's standards and intended changes in practice, auditors need full, detailed word-by-word comparisons of Proposed Standards and final standards to the current PCAOB standards and to the ISAs. For this particular set of Proposed Standards, due to the number of interim standards being superseded and replaced, it would also be helpful for the PCAOB to provide a high-level matrix indicating which Proposed Standards are replacing which interim standard(s). Additionally, we encourage the Board to clearly articulate in its Release to the final standards the expected changes in practice (going forward we recommend that such articulation be included in both proposed standards and in final standards). Similar to the method the Financial Accounting Standards Board (FASB) has used, this could be accomplished by including a section titled "Differences between this Statement and Current Practice." Providing this information will help auditors (1) obtain a better understanding of the impacts of the standards and (2) more efficiently and effectively implement new standards.	**Drafting Conventions**

Exhibit 2: Answers to PCAOB Questions

Audit Risk in an Audit of Financial Statements – Appendix 1

1. ***Does the Proposed Standard appropriately describe audit risk and its component risks?***

   No. Please refer to our Overall Comments regarding proposing and adopting an overall audit objectives standard, and our comments regarding paragraphs 2, 5, and 6 of Appendix 1 in Exhibit 1.

Audit Planning and Supervision – Appendix 2

2. ***Is it reasonable and appropriate to extend the Auditing Standard No. 5 requirement regarding consideration of matters important to the audit of internal control over financial reporting to audits of financial statements?***

   Please refer to our comments on paragraph 7 of Appendix 2 in Exhibit 1.

3. ***Is the direction regarding multi-location engagements reasonable and appropriate?***

   Please refer to our comments regarding paragraph 11 of Appendix 2 in Exhibit 1.

4. ***Is more direction needed regarding multi-location engagements? If so, in what areas is additional direction needed?***

   Please refer to our comments regarding paragraph 11 of Appendix 2 in Exhibit 1.

5. ***Are the responsibilities of the engagement partner for planning and supervision appropriate and reasonable, and is the proposed direction clear?***

   Please refer to our comments regarding paragraphs 19-20 of Appendix 2 in Exhibit 1.

Identifying and Assessing Risks of Material Misstatement – Appendix 3

6. ***Does the Proposed Standard clearly and adequately describe the auditor's responsibilities for performing risk assessment procedures?***

   No. Please refer to our Overall Comments regarding drafting conventions and our detailed comments on Appendix 3 in Exhibit 1.

7. ***Are the additional procedures in paragraph 13 that the auditor should consider performing when obtaining an understanding of the company and its environment reasonable and appropriate for audits of issuers? Should these procedures be specifically required for all audits, or is the responsibility to consider performing the procedures sufficient?***

Please see comments on paragraphs 11-19 of Appendix 3 in Exhibit 1.

8. ***Is the new requirement to assess certain matters related to the control environment component of internal control over financial reporting reasonable and appropriate? Is the difference between the required performance for an audit of internal control over financial reporting and an audit of financial statements only clear?***

   As the matters outlined in paragraph 26 are consistent with AS No. 5, we believe they are appropriate; however, we do not believe this guidance should appear in two places. Please refer to our comments on paragraphs 26-32 of Appendix 3 in Exhibit 1.

9. ***Is the additional direction regarding the period-end reporting process reasonable and appropriate for audits of financial statements only?***

   As the direction regarding period-end financial reporting in the Proposed Standard is the same as paragraph 32 of AS No. 5, we believe it is appropriate. However, we do not believe such guidance should appear in two places. Please refer to our comments on paragraphs 26-32 of Appendix 3 in Exhibit 1.

10. ***Are the requirements and direction regarding the auditor's responsibilities for evaluating design and implementation of controls as part of obtaining an understanding of internal control over financial reporting sufficient and clear? If not, what additional direction is needed?***

    Please refer to our comments regarding paragraphs 20-36 of Appendix 3 in Exhibit 1.

11. ***Does the additional description of the key engagement team members provide a better understanding of the expected participants in the discussion?***

    Yes, the description of the key engagement team members is sufficient.

12. ***Does the discussion of significant risks in this standard provide sufficient direction to enable auditors to identify significant risks?***

    No. The discussion of significant risks in paragraph 63 would be enhanced by adding guidance similar to that in paragraphs A112-A114 of ISA 315, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*. Please refer to additional comments about this Proposed Standard in Exhibit 1.

13. ***Should the Proposed Standards include specific requirements and direction regarding documentation, e.g., summaries of the identified and assessed risks and the linkage to the auditor's responses?***

    No. As documentation requirements are contained in AS No. 3, we do not believe additional specific documentation requirements are needed in the Proposed Standards.

<u>The Auditor's Response to the Risks of Material Misstatement – Appendix 4</u>

14. ***Does the Proposed Standard clearly describe the auditor's responsibilities regarding tests of controls in integrated audits and in audits of financial statements only?***

    No. Please refer to our comments regarding paragraphs 14-39 of Appendix 4 in Exhibit 1.

15. ***Are the requirements and direction regarding tests of controls appropriately aligned with Auditing Standard No 5?***

    Please refer to our comments regarding paragraphs 14-39 of Appendix 4 in Exhibit 1.

16. ***Does the Proposed Standard clearly describe the auditor's responsibilities regarding substantive procedures?***

    Please refer to our comments on paragraphs 11, 41, 45, and 48 of Appendix 4 in our Significant Detailed Comments and Exhibit 1.

<u>Evaluating Audit Results – Appendix 5</u>

17. ***Does the Proposed Standard clearly describe the auditor's responsibilities regarding the evaluation of audit results?***

    No. Please refer to our comments on Appendix 5 in Exhibit 1.

18. ***Are the requirements and direction regarding the accumulating identified misstatements and evaluating uncorrected misstatements appropriate and adequate?***

    No. Please refer to our comments on paragraphs 14, 15, 16, 18, 19, and 20 of Appendix 5 in Exhibit 1.

19. ***Are the requirements and direction regarding the evaluation of the results of the integrated audit appropriately aligned with Auditing Standard No. 5?***

    The requirements regarding the evaluation of the results of the integrated audit are the same as those included in AS No. 5 and, as such, are appropriately aligned. However, we do not believe these requirements should be repeated. Please refer to our comments on paragraphs 41-44 of Appendix 5 in Exhibit 1.

<u>Consideration of Materiality in Planning and Performing an Audit – Appendix 6</u>

20. ***Are the requirements and direction in this standard appropriately aligned with the concept of materiality as described in the courts' interpretation of the federal securities laws?***

Please refer to our comments on paragraph 3 of Appendix 6 in Exhibit 1.

21. ***Does the Proposed Standard sufficiently and clearly describe the auditor's responsibilities regarding (a) establishing an appropriate materiality level for the financial statements as a whole and (b) establishing a lower materiality level or levels for particular accounts or disclosures? If not, what additional direction is needed?***

No. We believe the Proposed Standard should provide more guidance on how to establish the materiality level for the financial statements as a whole as well as the lower level of materiality for particular accounts or disclosures. Paragraphs A3 through A5 of ISA 320, *Audit Materiality*, provide a list of factors that may affect the appropriate benchmark to use, examples of such benchmarks, and the relevant financial data to be used in relation to the chosen benchmark. Paragraph A10 of ISA 320 provides examples of factors that may indicate the need for lower materiality levels for particular accounts or disclosures. Similar guidance would be useful in assisting the auditor in applying the requirements in the PCAOB standard.

22. ***Is the use of the term "tolerable misstatement" in the Proposed Standard appropriate and sufficiently clear?***

No. Please refer to our comments on paragraphs 8 and 9 of Appendix 6 in Exhibit 1.

<u>Audit Evidence – Appendix 7</u>

23. ***Does the Proposed Standard clearly describe the principles necessary for evaluating the sufficiency, relevance, and reliability of audit evidence?***

No. Please refer to our comments on Appendix 7 in Exhibit 1.

24. ***Are the auditor's responsibilities regarding the authentication of documents reasonable and appropriate?***

Yes.

25. ***Are the requirements and direction related to selecting items for testing appropriate and clear?***

Please refer to our comments regarding paragraph 27 of Appendix 7 in Exhibit 1.

26. ***Are the five categories of assertions in this standard sufficient or should they be expanded? If so, how would such expansion affect auditor performance?***

The five categories of assertions are sufficient and consistent with other standards.

Exhibit 3: Editorial Comments

Appendices 1-7

Appendix 2, Paragraph 10 – The Proposed Standard indicates "the auditor should develop a written audit plan…" The term "written" can be misleading in the age of electronic workpaper documentation. In addition, this creates an unnecessary inconsistency with the ISAs (See ISA 300, paragraph 8) and the exposure draft of the related proposed SAS (AU 311, paragraph 8), neither of which include the word "written" in relation to the audit plan. We recommend the word "written" be deleted.

Appendix 3, Paragraph 21 – In the Note to this paragraph it is not clear why the second sentence is not part of ICFR. This Note states:

> The auditor also might obtain an understanding of certain controls that are not part of internal control over financial reporting. For example, if the auditor plans to use information produced by the company, he or she should obtain an understanding of controls over the completeness and accuracy of that information if necessary to evaluate the sufficiency and appropriateness of the information.

However, controls over completeness and accuracy of information are part of ICFR. Perhaps the PCAOB is intending to refer to situations in which the auditor plans to use operational information produced by the company; if so, this paragraph should be changed accordingly.

Appendix 3, Paragraph 32 – The Note to this paragraph refers to "monitoring activities." This appears to be a typographical error, as we believe this should refer to obtaining an understanding of "the period-end financial reporting process."

Appendix 3, Paragraph 46 – We suggest deleting the Note to paragraph 36. Similar guidance related to a one-person engagement could apply to many other paragraphs within the Proposed Standards; however, such guidance is not provided. We also believe that the guidance provided is self-evident and, therefore, not particularly helpful. As such, we suggest deleting it here.

Appendix 3, Paragraph 56 – The Note to 56c seems to relate more to item b, but seems to repeat what item b is stating. We suggest deleting the Note after item c.

Appendix 4, Paragraph 38 – This paragraph implies that the financial statement audit is separate from the audit of ICFR. Rather than referring to an integrated audit, it refers to the audits separately. We suggest deleting the words "for the audit of internal control and the audit of the financial statements" as well as the words "during the financial statement audit."

Appendix 4, Paragraph 43 is redundant of paragraph 7b. We recommend paragraph 43 be deleted.

Appendix 4, Paragraph 50 – The first sentence of this paragraph does not make sense. Either a word is missing, or perhaps the word "detects" should be moved from after "risks of material misstatement" to after "if the auditor."

Appendix 5, Paragraph 27 – Initially this paragraph refers to "potential bias" but then this changes to "bias" in the last part of the sentence. This paragraph should refer to "potential bias" in both cases.

Appendix 7, Paragraph 13 – The first sentence is redundant of paragraph 4. The first sentence of paragraph 13 should be deleted.

Appendix 8 Conforming Amendments

General Comment – While we agree with replacing "competent" with "appropriate" throughout the standards, this change results in the phrase "sufficient appropriate evidential matter." The entire phrase should be replaced with "sufficient appropriate audit evidence" to be consistent with the title of Appendix 7 and language used in the Proposed Standards.

AU 150 – Footnote 2 to paragraph .04 was deleted. Rather than deleting this footnote reference ("See section 312, *Audit Risk and Materiality in Conducting an Audit*."), a new reference to the appropriate risk assessment standard should be added.

AU 230 – Within footnote 3 to paragraph .06, the reference to AU 311 was deleted. Rather than delete this reference, a reference to the Proposed Standard, *Audit Planning and Supervision*, should be added. Also, a reference to paragraph .08 of the Proposed Standard, *Audit Evidence*, is included in paragraph .12 after the sentence discussing documentation authentication. We believe this reference should be to paragraph .09 of Proposed Standard, *Audit Evidence*, which discusses the auditor's responsibilities related to documentation authentication.

AU 316 – The following paragraph is deleted from Footnote 2 of paragraph .01:

> Auditors are sometimes requested to perform other services related to fraud detection and prevention, for example, special investigations to determine the extent of a suspected or detected fraud. These other services usually include procedures that extend beyond or are different from the procedures ordinarily performed in an audit of financial statements

We recommend such paragraph be retained in the standard.

A reference to paragraph .53 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, was added to the fifth bullet of paragraph .53. We recommend paragraph .54 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, be added as a reference in addition to paragraph .53, as both paragraphs discuss inquiring of others regarding fraud.

Through the Conforming Amendments the phrase "in accordance with GAAS" in Footnote 21 and 22 would be changed to "an audit of financial statements." We recommend using the phrase "in accordance with PCAOB audit standards."

AU 317 – The last sentence of paragraph .13, which has been revised, should include the phrase "For example" at the beginning of this sentence. The revised paragraph would appear as follows:

> In evaluating the materiality of an illegal act that comes to his attention, the auditor should consider both the quantitative and qualitative materiality of the act. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

AU 322 – Based on the proposed Conforming Amendments, footnote 3 to paragraph 4 contains a reference to Proposed Standard, *Identifying and Assessing Risks of Material Misstatement*; however, there is no discussion of internal audit as being part of the entity's control environment in Appendix 3. We suggest either such a discussion be added, or this footnote be deleted.

Additionally, we recommend changing the reference to paragraph .44 of Proposed Standard, *The Auditor's Responses to the Risks of Material Misstatements*, in Footnote 5 to paragraph 18 to Proposed Standard, *Audit Evidence*.

AU 9326 – We recommend deleting the reference to section 313 in paragraph .04, as section 313 is superseded by the Proposed Standards.

AU 329 – While paragraph .03 was deleted (see text below), this paragraph still appears to be relevant to substantive analytical reviews; therefore, we recommend retaining this paragraph.

> Understanding financial relationships is essential in planning and evaluating the results of analytical procedures, and generally requires knowledge of the client and the industry or industries in which the client operates. An understanding of the purposes of analytical procedures and the limitations of those procedures is also important. Accordingly, the identification of the relationships and types of data used, as well as conclusions reached when recorded amounts are compared to expectations, requires judgment by the auditor.

Footnote 2 to paragraph .20 was deleted; however, we question the deletion of this footnote and recommend retaining it and providing an updated reference to the applicable Proposed Standard.

Footnote 3 to paragraph .21 was deleted. We recommend retaining this footnote and inserting a reference to the appropriate Proposed Standard.

AU 332 – We recommend editing the revision to paragraph .35 to state "provides direction" rather than "provide directions" as the subject of this sentence is the Proposed Auditing Standard, not the paragraph references.

AU 342 – We recommend editing the revision to paragraph .14 by changing "discuss" to "discusses" as the subject of this sentence is the Proposed Auditing Standard, not the paragraph references.

AU 350 – Paragraph .04 of Proposed Standard, *Audit Evidence*, which is referenced in Paragraph .07, does not describe the concept of "a reasonable basis for an opinion." We recommend referencing to AU 230.11.

In paragraph .09, we recommend the reference should be to paragraphs 3 through 10 of Proposed Standard, *Audit Risk in an Audit of Financial Statements*, as opposed to paragraphs 5 through 10.

We recommend removing the remaining references to section 313 that still exist throughout this section.

AU 9543 – Footnote 4 to paragraph .16, which included a reference to where the term "assistants" is defined, was deleted. Within paragraph .16, the term "assistants" is retained; however, the Proposed Standards use the phrase "engagement team members." We recommend replacing the term "assistants" with "engagement team members" throughout the standards.

AU 380 – We recommend changing the reference to section 316A in the last sentence of Footnote 5 to section 316.

ET 102 – The reference in footnote 1 to paragraph .05 has been revised to refer to the Proposed Standard, *Audit Planning and Supervision*. As with the original footnote reference, a specific paragraph reference to this standard should be included.

Ernst & Young LLP
5 Times Square
New York, NY 10036

Tel: 212 773 3000
www.ey.com

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

18 February 2009

Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Conforming Amendments to PCAOB Standards, PCAOB Rulemaking Docket Matter No. 026

Dear Office of the Secretary:

Ernst & Young LLP (Ernst & Young) is pleased to submit this comment letter to the Public Company Accounting Oversight Board (PCAOB or the Board) in response to the PCAOB's request for comment regarding the proposed auditing standards related to the auditor's assessment of and response to risk (the proposed standards).

We support the issuance of the proposed standards and the PCAOB's objective to update its existing interim standards to reflect improvements that firms have made in risk-based audit methodologies. We also concur with the Board's recognition that risk assessment, appropriately applied, should underlie the entire audit process and result in audit procedures tailored to the company's size and complexity. We strongly support the Board's effort to eliminate unnecessary differences between its risk assessment standards and other risk assessment standards, particularly those of the International Auditing and Assurance Standards Board (IAASB) and the AICPA Auditing Standards Board (ASB). As discussed further in our comments below, we strongly support convergence of auditing standards and we urge the PCAOB to continue to further consider and integrate its standard-setting process with those of the other standards-setters. We believe that considering the work of other standards-setters will result in a more effective and efficient standard-setting process and increased understanding of the auditing standards, which should facilitate implementation by auditors.

We are aware of the challenge of developing risk assessment standards that provide sufficient direction to the auditor to identify, assess and respond to risk appropriately, yet allow and encourage the appropriate use of professional judgment. We believe it is very important that auditors use sound professional judgment to identify and address those risks that, if not addressed, could result in an unacceptable risk that the auditor will not obtain reasonable assurance that the financial statements are free of material misstatement. We also believe it is very important to recognize that the judgments made regarding the identification and assessment of risks, determining the nature, timing and extent of audit procedures, and what constitutes sufficient appropriate audit evidence, are necessarily dependent on the facts and circumstances known to the auditor during the conduct of the engagement.

We offer a number of overall comments below related to the proposed standards, including their relationship to other PCAOB standards and the drafting conventions used in their development. We also provide more detailed comments on each individual proposed standard in an attachment to this letter.

We would be pleased to discuss any of our comments with members of the PCAOB or its staff.

Sincerely,

Ernst + Young LLP

Overall Comments Related to the Proposed Standards

Relationship of Proposed Standards to Auditing Standard No. 5 (AS 5)

Paragraph 7 of the proposed standard, *Identifying and Assessing the Risks of Material Misstatement*, states that "the risks of material misstatement of the financial statements are the same for both the audit of internal control over financial reporting and the audit of the financial statements. Accordingly, the auditor's risk assessment procedures should apply to both the audit of internal control over financial reporting and the audit of the financial statements." We agree. However, we believe that the current structure of the proposed standards may lead some to question whether the risk assessment process is different for an audit of the financial statements only (for example, an audit of the financial statements of a non-accelerated filer) versus an audit of the financial statements as part of an integrated audit (one that includes an audit of the issuer's internal control over financial reporting).

Under a risk-based approach, an auditor is required to obtain an understanding of the entity and its environment, including its internal control, and to assess the risks of material misstatement. These fundamental requirements are applicable whether the auditor is performing an integrated audit or an audit of the financial statements only. However, the proposed standard, *Audit Risk in an Audit of Financial Statements*, seems to suggest that there are separate and distinct considerations of audit risk for the financial statement component of an integrated audit versus an audit of the financial statements only. For example, paragraph 1 states that the proposed standard establishes requirements and provides direction regarding the auditor's consideration of audit risk in an audit of the financial statements. The note to paragraph 1 states that AS 5 establishes requirements and provides direction regarding the auditor's consideration of risk in an audit of internal control over financial reporting.

In addition, we find the Board's approach of combining the proposed standards with AS 5 to be inconsistent. For example:

- Guidance from AS 5 is incorporated in some places in the proposed standards (for example, the bullet points in paragraph 7 of the proposed standard, *Audit Planning and Supervision*, are nearly identical to those in paragraph 9 of AS 5 while paragraphs 14 - 16 of the proposed standard, *The Auditor's Responses to the Risks of Material Misstatement*, repeat existing paragraphs in AS 5).

- In other places, only reference to AS 5 is made rather than repeating its language (for example, footnote 16 to paragraph 22 of the proposed standard, *The Auditor's Responses to the Risks of Material Misstatement*, footnote 5 to paragraph 6 and footnote 25 to paragraph 65 of the proposed standard, *Identifying and Assessing Risks of Material Misstatement*). These references would suggest that an auditor performing an audit of the financial statements only would be required to comply with the referenced paragraphs of AS 5. We do not believe that was the Board's intent.

We also note that AS 5 contains additional guidance related to risk assessment procedures that is not included in the proposed standards. For example, Paragraph 21 of AS 5 requires the auditor to use a top-down approach to the audit of internal control over financial reporting, but this approach is not discussed in the proposed standards. We believe that a top-down, risk-based approach is fundamental to the planning and scoping of any financial statement audit and contributes to both audit effectiveness and efficiency.

As a further example of guidance in AS 5 that is not included in the proposed standards, paragraphs 34 through 38 of AS 5 provide for certain basic risk assessment activities to be undertaken to identify risks at the assertion level. AS 5 then goes on to state that frequently the most effective way to carry out these risk assessment activities is to perform a walkthrough. The proposed standards do not contemplate the risk assessment activities noted in paragraphs 34 through 38 of AS 5, nor do they acknowledge the effectiveness of performing walkthroughs to identify risks of material misstatement.

Because the risk assessment process should be the same for an audit of the financial statements only as well as the financial statement component of an integrated audit, we recommend the Board incorporate into the proposed standards (or other interim PCAOB standards as appropriate) all guidance relating to identifying, assessing and responding to risks in an audit of the financial statements (whether for an audit of the financial statements only or as part of an integrated audit) with appropriate conforming changes to AS 5. As a result, AS 5 would only include the additional guidance for performing an audit of internal control over financial reporting as part of an integrated audit. We believe this would make clear to auditors that the fundamental concepts of a risk-based approach apply to any audit conducted in accordance with PCAOB standards.

Integration of Fraud Guidance

We acknowledge the benefits of better integration of fraud considerations into the risk assessment process. We also believe that the consideration of fraud risks and awareness to the possibility of fraud should be continuous throughout the audit and not a "bolt on" to other audit procedures. However, we believe that there is a benefit to auditors having a single standard that explains the auditor's responsibilities related to fraud. Extant AU 316, *Consideration of Fraud in a Financial Statement Audit* (AU 316), provides an effective framework for gathering information and using that information to better understand, identify and respond to the risks of material misstatement due to fraud. It describes the responsibilities of the auditor throughout all phases of the audit, beginning with understanding fraud and its characteristics and ending with documenting the auditor's consideration of fraud.

We are concerned that, after reflecting on the proposed conforming amendments, there will no longer be a single place in the auditing standards that presents a complete picture of the auditor's responsibilities related to fraud. We also are concerned about a lack of clarity as to how the remaining requirements in AU 316 link to fraud-related requirements that will now be in other places throughout the standards. We are not convinced that auditor performance will be influenced to any significant degree by spreading fraud-related requirements throughout the standards. We believe that additional guidance for auditors on the types of procedures to perform in response to identified fraud risks, along with additional tools and enablers, will yield better results in terms of the auditor's ability to detect material financial statement fraud.

Therefore, we recommend that the Board retain AU 316 in its entirety, and include references, as appropriate, to the existing requirements in AU 316 in other sections of the PCAOB auditing standards. We note that the Board has taken this approach in paragraph 13 of the proposed standard, *The Auditor's Responses to the Risk of Material Misstatement.* This paragraph summarizes the requirements in AU 316.58 - 67 related to the auditor's required procedures to specifically address the risk of management override of controls and appropriately incorporates these requirements into the auditor's process of responding to risks of material misstatement, while still maintaining the requirements and guidance in AU 316.

We offer additional detailed comments related to the fraud content in the proposed standards for the Board's consideration in the attachment to this letter.

Use of Presumptively Mandatory Requirements

In certain instances, the Board's intent regarding the auditor's responsibilities embodied in the proposed standards is unclear. For example, the use of the terms "should evaluate," "should consider," "should include," "should take into account" and "should assess" throughout the proposed standards may lead to confusion as to the specific activities to be performed by the auditor. The Board's Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards* (Rule 3101), states that the word "should" indicates responsibilities that are presumptively mandatory. Rule 3101 also explains that, if a Board standard provides that the auditor "should consider" an action or procedure, consideration of the action or procedure is presumptively mandatory, while the action or procedure is not. Rule 3101 does not discuss or provide direction relative to the various other uses of the word "should" throughout the proposed standards. We believe that the Board's variation in the use to the term "should," without discussion of the intent of such uses, causes confusion regarding what is expected in terms of auditor performance. In addition, by using a formulation different from that used in extant PCAOB standards, there may be an implication that the PCAOB expects a different auditor action.

We suggest that the Board use the same terminology as is used in extant standards, if the auditor responsibility is intended to be the same. If the responsibility is not intended to be the same, we recommend the Board clarify its expectation of auditors both in terms of the specific thought process or action required, and the documentation thereof.

Distinction between Mandatory and Presumptively Mandatory Requirements

We support the Board's infrequent use of "must" in the proposed standards. However, we recommend that the Board review its standards for consistency in the use of "must" and "should." For example, AS 5, paragraph 9 states that "the auditor *should* properly plan the audit of internal control over financial reporting and properly supervise any assistants," but paragraph 3 of the proposed standard, *Audit Planning and Supervision,* states that "the auditor *must* adequately plan the audit and properly supervise the members of the engagement team."

In contrast to the PCAOB drafting convention, we note that the IAASB only uses one term throughout the clarified ISAs in describing auditor requirements. In light of the infrequent use of the word "must" throughout the PCAOB standards as well as the variation in the use of the word "should" as noted above, we ask the Board to consider whether this is an appropriate time to challenge Rule 3101 and consider an overall "clarity project" to further refine the drafting conventions that will be used throughout all of the PCAOB standards. This would provide the Board the opportunity to challenge whether the use of both "must" and "should" is still necessary to distinguish between mandatory and presumptively mandatory requirements.

Prescriptive Requirements

The Board states in its Release to the proposed standards (page 6): "The proposed standards also reflect the Board's recognition of the importance to the audit process of sound professional judgment. As under the PCAOB's existing auditing standards, auditors would have to exercise professional judgment to determine how best to fulfill the requirements of the proposed standards under particular circumstances. "

We agree with the statement above and also believe that auditing standards should be more "principles-based" than "rules-based" in order to provide the auditor with the opportunity to apply professional judgment in performing the audit. However, we believe that in several instances the proposed standards include unnecessarily prescriptive requirements that limit the auditor's ability to use judgment in the circumstances or to scale the audit. We have noted some of these instances in the attachment to this letter.

We also ask the Board to carefully consider each use of the word "should" to make sure that the specific performance requirement is clear to the auditor and provide additional guidance as necessary to support or enhance the auditor's understanding of the requirement.

The Relationship of the PCAOB Standards to Other Auditing Standards

We fully support the Board's consideration of the work of other standards-setters, as evidenced by the efforts to consider overall alignment of the proposal's organizational structure and guidance with the corresponding risk assessment standards of the IAASB. We acknowledge the steps taken, and urge the PCAOB to continue to implement the objective in the Board's strategic plan for 2008-2013 to "participate in the work of, and engage with, other standards-setting bodies to benefit from, and as appropriate incorporate, new developments and techniques to promote high quality audits worldwide." We believe that increased and ongoing involvement by the PCAOB with other standard-setting bodies will enhance the effectiveness of all standards-setters; improve the consistency and understanding of auditing standards around the world; eliminate unnecessary differences among the standards; and clarify the rationale for and understanding of the effect of appropriate differences that remain, such as those necessitated by an integrated audit performed for legal or regulatory reasons. These benefits will enhance auditors' understanding, implementation, and consistent execution of standards on all the audits they perform, not just those subject to the Board's oversight.

We acknowledge and strongly support the comparison in Appendix 10 of significant differences in requirements between the Board's proposed standards and those of the corresponding ISAs of the IAASB. The recent exposure by the ASB of its clarified risk assessment standards similarly includes an analysis of differences between its proposed standards, the PCAOB's proposed standards, and the ISAs. Such comparisons represent a positive step in promoting greater convergence of auditing standards and in articulating the reasons for differences. Some of our comments in the attachment to this letter identify areas in which we believe greater convergence could be achieved without jeopardizing the Board's objective to issue robust standards directed to audits, including integrated audits, of SEC issuers. Further, we suggest that the Board consider providing more detailed rationale for differences between the proposed standards and the standards of both the IAASB and the ASB to assist auditors that serve both issuer and nonissuer clients in understanding and implementing the standards.

Drafting Conventions used by the PCAOB

As stated above, we support the PCAOB's objective to take into account the IAASB risk assessment standards in developing the proposed standards; however, we have concerns that adopting some of the drafting conventions used by the IAASB (for example, the use of objectives in each proposed standard), but not all of the clarity drafting conventions adopted by the IAASB, may cause some confusion or the perception of unintended differences between the two sets of standards. In addition, the adoption of these proposed standards will introduce a third "style" of standard that is inconsistent with the Board's other standards, as well as numerous conforming amendments, without a clear vision for integrating the standards in the future.

The IAASB and ASB both have undertaken projects to redraft all of their auditing standards in a consistent manner with the intent of promoting greater understanding and more consistent application of their standards by auditors, which in turn furthers the objective of audit quality. The IAASB's clarity project is nearing completion; the ASB's is in progress.

We encourage the Board to undertake a similar project to introduce greater consistency and clarity in its standards. Accordingly, we support the Board's intent to develop a concept release to obtain public comment and feedback regarding the Board's review of the interim standards, and suggest that the Board consider feedback on that concept release in connection with making revisions to the proposed standards prior to adoption.

Given the IAASB drafting conventions and our comments above, we offer the following comments for the PCAOB's consideration related to the drafting conventions of the proposed standards and future proposed standards.

Objectives

We support the use of objectives in the proposed standards but believe that it is necessary for the PCAOB to consider from the outset how objectives are intended to fit into the overall framework of PCAOB standards going forward. In the ISAs, for example, objectives of individual standards are intended to assist the auditor in planning and performing the audit to achieve the overall objectives of the auditor set forth in ISA 200 (Revised and Redrafted), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*. As stated in paragraph 20 of ISA 200, the auditor should use the objectives in relevant ISAs to (a) determine whether any audit procedures in addition to those required by the ISAs are necessary in pursuance of the objectives stated in the ISAs, and (b) evaluate whether sufficient appropriate audit evidence has been obtained. We believe that the Board should add objectives to each of its standards, not just the seven in the proposal, and similarly link them to an overarching standard that provides context for their use.

In addition, we believe that objectives should articulate a statement of purpose. We do not believe it is appropriate or necessary for objectives in individual standards to contain the "must" or "should" terminology governed by the Board's Rule 3101. Such words should be reserved for the requirements that support the objectives of the standards. Finally, we believe that some objectives in the proposed standards are overly broad (for example, the objectives in paragraph 2 of the proposed standard, *Evaluating Audit Results*, and paragraph 3 of the proposed standard *Audit Evidence*). Our recommendations for revising such objectives are included in the attachment to this letter.

Additional Guidance

Although we generally support the brevity of the proposed standards, there are some areas in which we believe the standards could be improved with additional explanatory guidance, some of which is included in extant PCAOB, IAASB or ASB standards. Examples of such areas are included in the attachment to this letter.

Scalability

We support the addition of guidance, where applicable, to assist auditors in achieving the objectives of the proposed standards for smaller, less complex companies. We believe that the IAASB's convention for including considerations for smaller, less complex entities throughout the ISAs is appropriate and ask the Board to consider that convention in drafting its standards.

Multi-location Audits

We note that the proposed standards, *Audit Planning and Supervision*, and *Identifying and Assessing Risks of Material Misstatement*, address some circumstances specific to multi-location audits. We believe that more comprehensive guidance related to performing an audit of the financial statements for a multi-location entity, particularly related to assessing risks and scoping the engagement, would be helpful. Therefore, we suggest that the PCAOB provide expanded guidance related to this topic throughout the proposed standards.

For example:

- Paragraph 11 of proposed standard, *Audit Planning and Supervision*, provides matters to consider regarding the selection of a particular location or business unit in a multi-location audit; however, no direction is provided for the auditor in determining the extent to which auditing procedures should be performed at selected locations once those matters have been considered.

- The note to paragraph 41 of proposed standard, *Identifying and Assessing Risks of Material Misstatement*, discusses how an auditor might assess information obtained in other engagements in a multi-location audit, but does not provide any guidance for obtaining an understanding of internal control at different locations, which is equally as challenging.

Effective Date

We note that the Board did not propose an effective date in the proposed standards. We understand that the effective date is dependent upon the timing of adoption of final standards, but encourage the

Board to provide sufficient time for firms to incorporate the standards into their respective audit methodologies and training programs prior to implementation.

Other Comments Related to the Proposed Standards

We present below our more detailed comments specific to each of the seven proposed standards and the conforming amendments to the PCAOB standards. To facilitate your review, we have referenced the detailed comments to the related overall comment in the body of our letter. In some instances, however, a comment does not relate back directly to an overall comment, in which case no reference is provided.

Appendix 1: Audit Risk in an Audit of Financial Statements

- Paragraph 5 defines the risk of material misstatement as "the risk that the financial statements are materially misstated due to error or fraud." This definition contrasts with the ISA 200 definition of the risk of material misstatement, which says "the risk that the financial statements are materially misstated prior to the audit." We believe that including the words "prior to the audit" makes it clear that the risk of material misstatement is the entity's risk. We therefore recommend adding these words to the first sentence in paragraph 5.
- We do not believe that paragraph 6 sufficiently describes the types of risks of material misstatement at the financial statement level or how to identify such risks. In addition, the proposed standard does not describe how risks of material misstatement at the financial statement level are assessed. Therefore, we recommend that the PCAOB include additional guidance similar to that in ISA 315 (Redrafted), *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment* (ISA 315), paragraphs A98-A101 related to the identification and assessment of risks of material misstatement at the financial statement level.

Appendix 2: Audit Planning and Supervision

- We believe that paragraph 2 is sufficient to describe the objective of the proposed standard. Therefore, we recommend that paragraph 3 be deleted from the proposed standard. [*Objectives*]
- Paragraph 7 states that "the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures." We believe that these are matters the auditor typically considers in planning an audit engagement but generally would not entail a detailed evaluation. We therefore recommend that the PCAOB use the phrase "should consider" rather than "should evaluate" in paragraph 7. [*Use of presumptively mandatory requirements*]
- We believe that certain matters discussed in paragraph 7 are more appropriately included as part of the discussion of the overall audit strategy assessment in paragraph 9. These matters, which relate more to auditor judgment and audit planning are as follows:
  - Knowledge of the company's internal control over financial reporting or other information relevant to identifying risks of material misstatement obtained during other engagements performed by the auditor;
  - The auditor's preliminary judgments about materiality, risk, and other factors relating to the determination of material misstatements and material weaknesses;
  - Preliminary judgments about the effectiveness of internal control over financial reporting.

- Included in the list of matters in paragraph 7 is "preliminary judgments about the effectiveness of internal control over financial reporting." We recommend that the Board revise this bullet point so that it is clear that it pertains to the *auditor's* preliminary judgments, which would be consistent with the bullet point related to materiality in paragraph 7.

- Paragraph 9b states that the auditor should determine the significant factors that affect the direction of the engagement team. It is not clear what is meant by "direction" of the engagement team. ISA 300 (Redrafted), *Planning an Audit of Financial Statements* (ISA 300), paragraph 7(c) requires the auditor to "consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts." We recommend that the Board consider the ISA 300 language to improve the clarity of the requirement in paragraph 9b.

- Paragraph 10 states that the auditor should develop a *written* audit plan (emphasis added). We suggest that the term "written" either be clarified to indicate that it can include both hardcopy and electronic documentation or that the reference to "written" be removed from the proposed standard.

- We recommend the following revision to paragraph 10b:

  "The planned nature, timing and extent of tests of controls and substantive procedures *at the assertion level*.

  We believe this revision to the requirement is consistent with the proposed standard, *Auditor's Responses to Risks of Material Misstatement,* and also with ISA 300 paragraph 8.

- We recommend the following revision to paragraph 12 to make the definition of "fraud risk" consistent with the other proposed standards:

  "e.g., based on a revised assessment of the risks of material misstatement or discovery of a previously unidentified *risk of material misstatement due to* fraud *("fraud* risk")."

- Paragraph 13 requires the auditor to "determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, apply the planned audit procedures, or evaluate audit results." Paragraphs 14 and 15 discuss specific requirements regarding the evaluation of whether an information technology ("IT") specialist is needed and the auditor's interaction with an IT specialist. The Board notes in Appendix 9 the prevalent use of specialists by auditors, such as forensic specialists, valuation specialists and actuarial specialists in addition to IT specialists. Therefore, we believe it would be helpful to indicate in paragraph 13 the different types of specialists that the auditor may use in connection with the audit. In addition, we believe that paragraph 15, including the footnote to that paragraph, should make clear that the requirement applies to any specialist that the auditor has decided to use. We believe it is particularly important to indicate that any specialist that functions as a member of the audit engagement team requires the same supervision as any other member of the engagement team. In addition, the auditor should have sufficient knowledge of the subject matter to be addressed by the specialist to enable the auditor to fulfill the requirements of paragraph 15.

Appendix 3: Identifying and Assessing Risks of Material Misstatement

- Paragraph 4b defines significant risk as "a risk of material misstatement that is important enough to require special audit consideration." Paragraph 4e of ISA 315 defines significant risk as "an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration." We believe the process of identifying significant risks is highly dependent on auditor judgment and experience and, therefore, recommend that the Board include the reference to the auditor's judgment in this definition. [*The relationship of the PCAOB standards to other auditing standards*]

- The reference in footnote 3 refers to a definition of *fraud* in AU 316. If the Board integrates relevant aspects of AU 316 into the proposed standards, we suggest that the Board include among its conforming amendments the following change to the last sentence of AU 316.05 to clarify that the term "fraud" as used in the Board's standards is an act that results in a material misstatement of the financial statements: *[Integration of fraud guidance]*

  For purposes of *PCAOB auditing standards* ~~the section~~, *fraud* is an intentional act that results in a material misstatement in financial statements that are the subject of an audit.

- We suggest the following revision to paragraph 13 to be consistent with the overall requirement to obtain an understanding of the company and its environment ("understanding of the company") in paragraph 8:

  Reading public information about the company relevant to the ~~evaluation of the likelihood of material financial statement misstatements~~ *identification of risks of material misstatement* and the effectiveness of the company's internal control over financial reporting;

- Paragraph 14 contains footnotes that define the terms "objectives," "strategies" and "business risks." We suggest including these terms and the related definitions in a "Definitions" section of the proposed standard versus including them in footnotes. *[Drafting conventions used by the PCAOB]*

- We do not believe the proposed standard is clear with respect to the auditor's responsibility to identify and assess risks relative to company performance measures. Paragraph 16 states that the purpose is to identify those performance measures that affect the risks of material misstatement. However, it is not clear from paragraph 17 how the auditor might consider such measures in the context of identifying and assessing the risks of material misstatement, or the extent to which the presence of such performance measures might result in a higher or lower level of assessed risk. We recommend that the Board clarify the auditor's responsibilities with respect to company performance measures, and include specific examples to help auditors better understand both the types of measures to be considered and how those measures affect the risks of material misstatement.

- The fourth bullet point in paragraph 19 requires the auditor to obtain an understanding of the degree of transparency of the application of significant accounting principles and related financial reporting processes. We believe that further clarification or guidance relative to the auditor's responsibility in this regard would be helpful, particularly regarding the meaning of "degree of transparency." *[Additional guidance]*

- Paragraph 22 states: "In obtaining an understanding of internal control, the auditor should evaluate the design of controls and determine whether the controls have been implemented." Paragraph 13 of ISA 315 provides that "when obtaining an understanding of controls *that are relevant to the audit*, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel" (emphasis added). We ask the PCAOB to clarify that the auditor does not need to evaluate the design and implementation of all controls, but rather only those controls that are relevant to the audit. Further, we suggest that the Board consider including a discussion of how walkthroughs may be used to accomplish the requirement (similar to paragraph 37 of AS 5). [*The relationship of the PCAOB standards to other auditing standards*]

- We suggest that the note to paragraph 32 be revised as follows:

  Note: In an integrated audit, the auditor's procedures for obtaining an understanding of the company's ~~monitoring activities~~ <u>*period-end financial reporting process*</u> might be performed in conjunction with the evaluation of entity-level controls, as discussed in paragraphs 26-27 of Auditing Standard No. 5.

- The note to paragraph 34 states: "For purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than that which is normally obtained in an audit of financial statements only." We do not believe this statement is correct. As previously stated in this letter, we believe the risk assessment process is the same for audits of internal control over financial reporting and financial statement only audits and, therefore, the auditor's process for *understanding* control activities to assess the factors that affect the risks of material misstatement and to design further audit procedures should be the same. We acknowledge that the further audit procedures may be different, but do not believe the auditor would gain an understanding of control activities for a broader range of accounts and disclosures. *[Relationship of proposed standard to AS 5]*

- We suggest changing the last bullet point to paragraph 48 as follows:

  ~~Communication~~ <u>*Discussion*</u> about the potential audit responses to the susceptibility of the company's financial statements to material misstatement due to fraud.

- Paragraph 52d requires the auditor to make fraud-related inquiries of accounting and financial reporting personnel, including, in particular, employees involved in initiating, authorizing, processing, or recording complex or unusual transactions ... " In addition, paragraph 53 requires the auditor to "inquire of others within the company about whether they have knowledge of fraud, alleged fraud, or suspected fraud."

  Paragraph 54 provides guidance to the auditor in determining which individuals within the company to whom the inquiries required by paragraphs 52d and 53 should be directed. It directs the auditor to "... assess who might reasonably be expected to have information that might be important to the identification and assessment of fraud risks ..." Although the concepts and the words are similar to the extant requirement in paragraph 24 of AU 316, we believe that this changes the nature of the requirement and, in doing so, makes the requirement more confusing and potentially difficult to implement in practice.

Paragraph 24 of AU 316 requires the auditor to make inquiries of others within the entity. It allows the auditor to use professional judgment in determining those to whom such inquiries should be directed, and paragraph 25 provides examples of others to whom the auditor may wish to direct these inquiries. Paragraph 24 also directs the auditor to consider whether there may be certain individuals that might provide information relevant to the identification of fraud risks or that would further corroborate information about fraud risks obtained from other sources. Unlike paragraph 54 of the proposed standard, it does not direct the auditor's inquiries only to these individuals.

We have always understood the requirement in paragraph 24 of AU 316 to suggest that the auditor should make a number of inquiries of accounting, financial and other personnel throughout the entity in the course of performing the audit. For example, in meeting with a member of the entity's accounting department to obtain an understanding of the processing of transactions and related controls, the auditor might ask if the employee has seen anything unusual in the processing of routine transactions or handling of exceptions in transaction processing that might suggest the possibility of management override of controls. In our view, these inquiries should be part and parcel of the ongoing dialogue that occurs throughout the audit process, and not limited to individuals who the auditor believes might possess information important to the identification and assessment of fraud risks.

We recommend that the Board challenge the construct and wording in paragraphs 52d, 53 and 54 to clarify the auditor's responsibilities regarding fraud-related inquiries of others in connection with the audit. In particular, we ask the Board to be cognizant of the potential difficulties for auditors to fulfill a requirement to make inquiries of accounting and financial reporting personnel in a large, multilocation entity without an explicit acknowledgment that the auditor can use professional judgment in determining those to whom the inquiries should be directed.

- Paragraph 56 states: "The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level." We believe the auditor's identification and assessment of the risks of material misstatement are made in the context of the auditor's determination of significant accounts and disclosures and their relevant assertions. That is, an auditor first determines whether an account or disclosure is significant and whether an assertion is a relevant assertion, and then assesses the risks of material misstatement related to those accounts and assertions. Therefore, we suggest that the Board consider moving the reference in paragraph 56e to the identification of significant accounts and disclosures and their relevant assertions to the introductory sentence of paragraph 56 to make it clear that the process of identifying, evaluating and assessing the risks of material misstatement described in 56a-d and f is accomplished after first identifying significant accounts and disclosures and their relevant assertions.

- We believe that paragraphs 64 and 65 of the proposed standard need to be clarified to clearly address that the auditor identifies or assesses fraud risks after taking into consideration an evaluation of the entity's programs and controls that address the risks. We suggest that the proposed standard incorporate language similar to the following from extant AU 316 paragraph 45 to address this:

> After the auditor has evaluated whether the entity's programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed into operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

We believe it should be clear to the auditor that if a control is identified that mitigates a fraud risk, then the auditor's response should be to test that control, and no further response to the risk of fraud may be required. Adding this explicit language will make the proposed standard consistent with the requirements of extant AU 316 paragraph 45. *[Integration of fraud guidance]*

- We do not believe that Appendix A - Consideration of Manual and Automated Systems and Controls has been referenced within the body of the proposed standard. We suggest that the Board add such a reference (for example, to paragraph 29) to clarify the intended purpose of the Appendix.

Appendix 4: The Auditor's Responses to the Risks of Material Misstatement

- Paragraph 1 states: "This standard establishes requirements and provides direction regarding designing and implementing appropriate responses to the risks of material misstatement." However, we believe that the standard should have a stronger link between the identification and assessment of risks of material misstatement and the response to those risks. We understand that the Board considered this matter. It concluded that obtaining sufficient appropriate audit evidence to support the auditor's opinion requires the auditor to adequately respond to the risks of material misstatement. Although related to the appropriateness of the auditor's risk assessments, the response is separate from the assessment.

  In each audit the auditor performs risk assessment procedures to determine where risks of material misstatement exist. Based on this assessment, the auditor designs and executes procedures to obtain sufficient appropriate audit evidence. The effectiveness with which the risk assessment is performed logically affects any audit response. The intrinsic relationship between risk assessment and the audit response is a fundamental aspect of the audit risk model. Therefore, we recommend that the standard include the concept that the auditor designs and implements appropriate responses to risks of material misstatement that he or she has identified and assessed as to the severity of risk. [*The relationship of the PCAOB standards to other auditing standards*]

- We suggest revising the objective in paragraph 3 as follows to be consistent with paragraph 3 of ISA 330 (Redrafted), *The Auditor's Responses to Assessed Risks* (ISA 330 and to better reflect an outcome-based approach that provides both specificity and a link to the requirements of the proposed standard *[Objectives]*:

  > The objective of the auditor is to obtain *sufficient appropriate audit evidence about the assessed* ~~address the~~ risks of material misstatement through *designing and implementing* appropriate ~~overall audit~~ responses ~~and audit procedures~~ *to those risks.*

- Paragraph 4e states that "The auditor should evaluate whether it is necessary to make general changes to the nature, timing or extent of audit procedures to adequately address the risks of material misstatement." We ask the Board to consider including additional guidance and examples to clarify the meaning of "general changes." *[Additional guidance]*

- Paragraph 5 includes a definition of "professional skepticism." We suggest the Board include this in a separate "Definitions" section within this proposed standard or reference AU 316.13. [*Drafting conventions used by the PCAOB*]

- We ask the Board to consider replacing the term "fraud risks" in Paragraphs 9, 11 and 12, and throughout the proposed standards with "identified fraud risks," which would be consistent with the use of this term in paragraph 10 of the proposed standard.

- Paragraph 10 refers to "his or her fraud risk assessment." We note that the conforming amendments to AU 316 have deleted the paragraphs related to the section "Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks" (AU 316.43 - 45). As such, we ask the Board to explain what is meant by "fraud risk assessment" in this proposed standard as the term in not introduced or used elsewhere. *[Integration of fraud guidance]*

- We note that the requirements to specifically address the risk of management override of controls in paragraph 13 of the proposed standard would still be included in the PCAOB's standards at AU 316.58 - 67 because no conforming amendments were made to delete these paragraphs from AU 316. We believe the approach taken in paragraph 13 illustrates how the Board could appropriately reference the relevant concepts from AU 316 into the proposed standards, while leaving AU 316 intact as a standard that addresses the auditor's complete understanding of fraud in an audit. We do, however, suggest the following revision to paragraph 13 to clarify that the proposed standard does not impose additional requirements on the auditor, but instead is repeating the requirements included in AU 316 [*Integration of fraud guidance*]:

  The auditor *is required by AU section 316 to* ~~should~~ perform audit procedures to specifically address the risk of management override of controls including:

- Paragraph 17 refers to the auditor's control risk assessments. Paragraph 18 refers to the flexibility given to the auditor to assess the risk of material misstatement below the maximum level because of reliance on controls. We ask the Board to clarify whether "control risk assessments" and the "assessment of the risk of material misstatement" are intended to have the same meaning, and if so, use consistent terminology within the proposed standard.

- Footnote 14 to paragraph 18 suggests that, when testing controls in a financial statement audit, the period of reliance on controls may be less than the full year (i.e., the period covered by the company's financial statements). We believe that additional guidance about how this concept would be applied should be included in the proposed standard. The application guidance in ISA 330, paragraph A32, provides an example of how evidence pertaining only to a point in time may be sufficient for the auditor's purpose and explains that controls over the entity's physical inventory counting at the period end may be an example of such a control. We recommend including examples such as this to clarify the meaning of this concept. [*Additional guidance*]

- Paragraph 19 requires the auditor to perform tests of controls "for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence" but provides no guidance to explain when such circumstances may arise. We believe the Board should consider including guidance about circumstances where the use of IT is integral to the ongoing conduct of an entity's business and no documentation of transactions is produced or maintained, other than through the IT system, as described more fully in paragraphs A120-121 of ISA 315; (paragraphs 119-120 of AU section 318, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*; or in paragraphs 68-69 of the Board's interim standard AU 319, *Consideration of Internal Control in a Financial Statement Audit. [Additional guidance]*

- The footnote to paragraph 22 states that paragraphs 37-38 of AS 5 provides direction on performing a walkthrough. We believe the guidance in paragraphs 37-38 of AS 5 should be more directly incorporated into the proposed standard because this guidance is relevant and valuable to any audit of financial statements. *[Relationship of the proposed standards to AS 5]*

- The Note to paragraph 25 states that to obtain evidence about the operating effectiveness of a control, the control must be tested directly, which is consistent with AS 5. We suggest including additional discussion to clarify the meaning of "tested directly." For example, we recommend adding the concept that while the absence of misstatements does not support the effective operation of a control, the absence of misstatements can inform the risk assessment associated with a control and, as such, affect the nature, timing and extent of testing of a control for operating effectiveness. [*Additional guidance*]

- We ask the PCAOB to challenge whether the requirement in paragraph 38, as well as the heading preceding it ("Assessing Control Risk") are appropriately included in this proposed standard. The objective of this proposed standard is to address the risks of material misstatement through appropriate overall audit responses and audit procedures. We believe that including a requirement to assess control risk at the assertion level may be better incorporated into the proposed standard, *Identifying and Assessing Risks of Material Misstatement*. Specifically, paragraph 56 of that standard provides the auditor with guidance related to assessing risks of material misstatement but does not implicitly require the auditor to assess either inherent or control risk. We ask the PCAOB to consider whether a discussion of assessing control risk would better fit in that context.

- We suggest removing the presumptively mandatory requirement from the second sentence of paragraph 49. We believe the requirement in the first sentence provides the appropriate level of direction for the auditor. The detailed procedures to perform should be determined by the auditor based on professional judgment. *[Prescriptive requirements]*

- We recommend that the first sentence of paragraph 50 be revised as follows:

If the auditor *detects* misstatements that he or she did not expect when assessing the risks of material misstatement ~~detects~~, the auditor should evaluate ...

Appendix 5: Evaluating Audit Results

- We believe that the objective in paragraph 2 is overly broad and does adequately address the objective of the standard. Therefore, we believe the following would be a more appropriate objective for the proposed standard and recommend the Board consider revising paragraph 2 in such a manner: [*Objectives*]

  The objective of the auditor is to evaluate the results of the audit to determine whether the audit evidence obtained is sufficient and appropriate to support the opinion on the financial statements.

- Paragraph 3b defines the term "misstatement." However, it is unclear whether the intent of the Board was to define "misstatement" or "material misstatement." We recommend that the Board consider the definition of misstatement from ISA 450, (Revised and Redrafted), *Evaluation of Misstatements Identified during the Audit* (ISA 450), paragraph 4(a), which states that a misstatement is "a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud." [*The relationship of the PCAOB standards to other auditing standards*]

- Paragraph 8 states that the nature, timing, and extent of the analytical procedures that should be performed during the overall review depend on the nature of the company and its industry. We do not believe this is generally the case in practice and also does not seem consistent with the requirement in paragraph 6, which is to perform overall analytical procedures to assess the auditor's conclusions and assist in forming an opinion on the financial statements. In most instances, such analytical procedures are similar to those performed during the risk assessment process. Therefore, we recommend that the proposed standard clarify the expectation of the auditor regarding the nature and extent of procedures to be performed in the overall review.

- Paragraphs 12 and 13 use the term "clearly trivial." We suggest that the proposed standard include language similar to the application guidance in paragraph A2 of ISA 450, which defines "clearly trivial" as follows: "Matters that are clearly trivial will be a wholly different (smaller) order of magnitude than established materiality, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial." By adding additional language such as this, we believe the auditor will be able to better understand what is meant by the term "clearly trivial" when accumulating and evaluating identified misstatements. [*Additional guidance*]

- Paragraph 14 states that "The auditor's accumulation of misstatements should include the auditor's best estimate of the total misstatement in the accounts and disclosures that he or she has tested, not just the amount of misstatements specifically identified." We suggest that the

Board provide additional guidance regarding what is meant by "best estimate" in this context and how the auditor would calculate a best estimate for all accounts and disclosures tested. [*Additional guidance*]

- Within paragraph 19 the words "detected in prior years" are used instead of "related to the prior year" as used in ISA 450 paragraph 11. We believe the ISA language provides better guidance for auditors because there may be misstatements detected in the current year that relate to the prior year. We also believe that the requirement does not accurately capture the requirements in Staff Accounting Bulletin 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides guidance on how the effects of prior year misstatements should be considered in quantifying a current year misstatement. We believe the ISA was drafted to be accounting framework neutral and therefore does not clearly address the effects of the iron-curtain versus the roll-over method. However, we recommend that the PCAOB standards be clear in this regard. [*The relationship of the PCAOB standards to other auditing standards*]

- We believe that the discussion of bias and the requirement for the auditor to "assess" bias in paragraph 25 should be strengthened. In our view, the proposed standard does not address the fact that the indicators of management bias also may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate, and whether the financial statements as a whole are free from material misstatement. The Board may find the discussion of bias in the financial statements addressed in ISA 700, *Forming an Opinion and Reporting on Financial Statements* (ISA 700), paragraph 12 and the application guidance noted in paragraph A2 helpful in this regard. [*Additional guidance*]

- Paragraph 28 states that "If the auditor concludes that the amount of an accounting estimate included in the financial statements is unreasonable or was not determined in accordance with the applicable accounting principles, he or she should treat the difference between the estimate and the closest reasonable estimate as a misstatement." We suggest that this paragraph be placed in the section of the proposed standard titled "Accumulating and Evaluating Identified Misstatements" because the paragraph deals more with whether a misstatement exists in an accounting estimate rather than the potential for management bias.

- We believe that the requirement in paragraph 32 is more appropriately placed in the proposed standard, *Identifying and Assessing the Risks of Material Misstatement*. Paragraph 30 discusses the requirement to evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of fraud risks and the need to modify the audit procedures to respond to those risks. We believe that a requirement for the auditor to assess the risks of material misstatement due to fraud throughout the audit is best linked with the requirements and guidance regarding the identification and assessment of those risks rather than in connection with the "after the fact" evaluation of audit results required by paragraph 30. [*Integration of fraud guidance*]

- We believe that paragraph 37 could be improved by including some language from paragraph 17b of ISA 700 and therefore recommend that the paragraph be edited as follows: [*The relationship of the PCAOB standards to other auditing standards*]

If the auditor has not obtained sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor should attempt to obtain further audit evidence.

Appendix 6: Consideration of Materiality in Planning and Performing an Audit

- We recommend that the Board provide examples in support of paragraphs 10 and 11 for situations in which the Board believes it is appropriate to conclude that the amounts "differ significantly" or the financial statements have "changed significantly," which would lead the auditor to reassess materiality or perform additional audit procedures as a result of differences in determined materiality amounts. [*Additional guidance*]

Appendix 7: Audit Evidence

- We suggest adding language from AU 326.02 to paragraph 2 to help clarify for the auditor what is meant by "other sources." We recommend the following sentence be added to paragraph 2: [*Additional guidance*]

  "Audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the audit opinion is based. *Other sources may include audit evidence obtained from previous audits and a firm's quality control procedures for client acceptance and continuance.*

- We recommend the following revision to the last sentence of paragraph 2:

  Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and any information *that the auditor is aware of* that contradicts such assertions.

- We do not believe that the objective as stated in paragraph 3 is clear. As written it appears to be nothing more than a slightly different formulation of the requirement in paragraph 4. In addition, the objective fails to capture the essence of the proposed standard, which is to design and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for the auditor's opinion. The Board may find the language in paragraph 4 of ISA 500 (Redrafted), *Considering the Relevance and Reliability of Audit Evidence* (ISA 500), helpful in this regard. [*Objectives*].

- We recommend that paragraph 6 be revised as follows to be consistent with ISA 500 paragraph 5(b): [*The relationship of the PCAOB standards to other auditing standards*]

  To be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based."

- We recommend that the Board consider providing additional guidance regarding the concept of relevance of audit evidence described in paragraph 7. Paragraph A27 of ISA 500 may be helpful in this regard. [*Additional guidance*]

- Paragraph A31 of ISA 500 indicates that generalizations about the reliability of certain kinds of audit evidence are subject to important exceptions. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a specialist engaged by management may lack objectivity. We recommend that the Board consider adding similar language to paragraph 8. [*Additional guidance*].

- As currently written, the proposed standard is silent on the use of evidence from previous audits. We recommend that the Board consider incorporating some of the application guidance from ISA 500 paragraph A11, which states that "audit evidence obtained from previous audits may, in certain circumstances, provide appropriate audit evidence where the auditor performs audit procedures to establish its continuing relevance." [*Additional guidance*]

Appendix 8: Proposed Conforming Amendments to PCAOB Standards

- Appendix 9 states that AU sections 350.23 to 350.38 have been amended to explain more specifically how the principles in the standard apply for determining sample sizes when nonstatistical sampling approaches are used. To this end, appendix 8 proposes to add paragraph .23A and to add a sentence to the end of paragraph .38 of AU section 350, *Audit Sampling*, which includes the following:

  > When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

  We believe that this addition to AU section 350 may lead auditors to infer that it is necessary to calculate sample sizes using both statistical and nonstatisical approaches, in all circumstances, in order to be in a position to be able to compare the sample sizes. We suggest that the PCAOB remove the phrase "or larger than" from the second sentence in the proposed sentence and add footnote 5 from the AU section 350.23 to clarify that is not the intent.

- Paragraph 1 of the proposed standard, *Audit Evidence*, uses the phrase "sufficient appropriate audit evidence." We note that the Board's conforming amendments would replace the term "competent" with the term "appropriate" throughout the extant standards. The resulting phrase in many instances is "sufficient appropriate evidential matter." We believe that the conforming amendments should be revised to replace the phrase "sufficient competent evidential matter" with "sufficient appropriate audit evidence" to be consistent with the phrase used in the proposed standard, *Audit Evidence*, and the related ISAs.

Federation of European Accountants
Fédération des Experts comptables Européens

18 February 2009

Mr. Keith Wilson
Associate Chief Auditor
Public Company Accounting Oversight Board
1666 K Street, NW
Washington DC 20006-2803
USA

Email: comments@pcaobus.org

Ref.: AUD/HvD/HB/SH

Dear Mr. Wilson,

Re: FEE Comments on PCAOB Release No. 2008-006: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards

FEE is pleased to provide you below with its comments on the Public Company Accounting Oversight Board (PCAOB) Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards of 21 October 2008 (the Proposed Auditing Standards).

FEE is the Fédération des Experts comptables Européens (Federation of European Accountants). It represents 43 professional institutes of accountants and auditors from 32 European countries, including all of the 27 EU Member States. In representing the European accountancy profession, FEE recognises the public interest. It has a combined membership of more than 500.000 professional accountants, working in different capacities in public practice, small and big firms, government and education, who all contribute to a more efficient, transparent and sustainable European economy.

FEE's objectives are:

- To promote and advance the interests of the European accountancy profession in the broadest sense recognising the public interest in the work of the profession;
- To work towards the enhancement, harmonisation and liberalisation of the practice and regulation of accountancy, statutory audit and financial reporting in Europe in both the public and private sector, taking account of developments at a worldwide level and, where necessary, promoting and defending specific European interests;
- To promote co-operation among the professional accountancy bodies in Europe in relation to issues of common interest in both the public and private sector;
- To identify developments that may have an impact on the practice of accountancy, statutory audit and financial reporting at an early stage, to advise Member Bodies of

such developments and, in conjunction with Member Bodies, to seek to influence the outcome;

- To be the sole representative and consultative organisation of the European accountancy profession in relation to the EU institutions;
- To represent the European accountancy profession at the international level.

The benchmark auditing standards are the clarified International Standards on Auditing (ISAs)

For over ten years, FEE has been advocating for the use of the (clarified) ISAs in the European Union (EU). In the meantime, the worldwide use of the ISAs has steadily expanded over the last few years, making them the global benchmark auditing standards.

We therefore welcome the PCAOB's initiative to align its standards with the clarified ISAs as a step towards the ultimate worldwide application of one set of auditing standards for capital market entities and also other entities.

We also welcome the update of the PCAOB's risk standards, reflecting the importance the PCAOB attaches, and is right to attach, to the new risk approach (i.e. risk assessment and responses to risk) to the audit which was introduced into the ISAs a few years ago.

We also support the clarified ISAs, have commented on each of them, and support further convergence. These Proposed Auditing Standards from the PCAOB are therefore very welcome. In an environment of convergence of accounting standards, the globalisation of auditing standards will facilitate consistency in the auditing of financial statements. The alternative is cumbersome questionnaires covering differences in auditing standards that detract from an efficient and effective audit.

We recognise that at this stage, the PCAOB issues standards separately and with differences from those of the IAASB because the PCAOB standards need to take into account U.S. securities law and U.S. Securities and Exchange Commission (SEC) and other PCAOB rulemaking on these laws. Additionally, seen the PCAOB has chosen for an integrated audit approach on both the financial statements and the internal controls of an entity, we understand that there are differences between the PCAOB auditing standards and the (clarified) ISAs.

However, we believe that it is not conducive to international convergence of auditing standards for the PCAOB to write auditing standards that differ from the (clarified) ISAs at a technical level for other reasons: the (clarified) ISAs reflect the product of an intensively overseen and thorough due process involving considerable consultation at an international level.

We noted a wide range of differences not identified by the PCAOB of which we note just a few below:

- The distinction between audit procedures on a financial statements level and on an assertion level is not always drawn systematically in the Proposed Auditing Standards like it is done in the clarified ISAs;
- The distinction between requirements pertaining to management as opposed to those charged with governance or the board of directors is not always pronounced clearly in the Proposed Auditing Standards like it is included in the clarified ISAs;
- The introduction in the Proposed Auditing Standards of far reaching requirements to compensate for the lack of an auditing standard on group audits like ISA 600[1] makes the Proposed Auditing Standards to be less comprehensive and unduly burdensome;
- There are requirements for substantive procedures on *all* significant risks, with little scope for the combination of work on controls and analytical procedures as required by clarified ISAs; this may be onerous. Detailed substantive testing for significant risks is flawed logically; *detailed* checking is not the right response to significant risks;
- There is a great number of presumptively mandatory ‘shoulds’ in the Proposal Auditing Standards (a construction rejected by the IAASB).

The differences we have noted in the bullet points above are significant. We believe that if they were addressed this would be helpful in eliminating unnecessary differences between PCAOB Standards and Clarified ISAs.

A number of European Union (EU) Member States have successfully adopted a standard-setting model whereby the basis of the auditing standards are the full (clarified) ISAs with additions that address specific national requirements. The PCAOB should consider this model particularly as we believe it would facilitate reliance upon other regulators in the PCAOB’s inspection process. The PCAOB has recently proposed amendments to its rules in order to help fulfil its inspection mandate.

[1] ISA 600, Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)

Avenue d’Auderghem 22-28 • B-1040 Brussels • Tel: +32 (0)2 285 40 85 • Fax: +32 (0)2 231 11 12 • secretariat@fee.be • www.fee.be

The fraud risk auditing standard should be more balanced

FEE is in favour of the introduction of a fraud risk auditing standard but the clarified ISAs have a great deal more on this in the application material than is included in the Proposed Auditing Standard. Application material is not just about the extent and effectiveness of work on fraud, but also about efficiency and ensuring that auditors do not do too much.

With the lack of application material, there is also a danger that the public expectations in respect of the auditor's ability to detect fraud may exceed the actual ability given the nature of the inherent limitations relating to fraud. The PCAOB needs to mention these limitations in its various pronouncements so as to ensure the "expectation" gap is not widened.

The objectives in the Proposed Auditing Standards should be aligned to the objectives in the clarified ISAs

We support the inclusion of an objective in each standard to clarify the objective of the requirements and act as a guide to the auditor in considering whether this has indeed been achieved by the audit work performed. It is however not clear why the PCAOB has chosen to deviate from the objectives included in the comparable clarified ISAs.

The due process for Proposed Auditing Standards could be enhanced

We welcome the 120 day comment period for a document of such extensiveness and importance as a step in improving the PCAOB's due process. Professional accountancy bodies and organisations such as our own, which wish to confer with their members or counterparts on such issues, need to be accorded adequate time to do so if the comments they might wish to submit are to be representative and well-deliberated.

We also support the comments made by Daniel L. Goelzer in relation to the need for further development of due process. Standards of such international significance require a transparent due process throughout their development. Open public hearings should be considered given the need for a degree of openness with these particularly important standards.

We regret that no implementation date is suggested in the Proposed Auditing Standards. The implementation date of new standards needs to be announced as early as possible to allow ample time for the standards to be embedded in the audit methodology, audit training and education, etc of audit firms and professional accountancy bodies.

For further information on this letter, please contact Mrs. Hilde Blomme at +32 2 285.40.77 or via email at hilde.blomme@fee.be from the FEE Secretariat.

Yours sincerely,

Hans van Damme
FEE President

financial executives international

February 18, 2009

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 026

Dear Board:

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") wishes to share its views on the Public Company Accounting Oversight Board ("PCAOB") Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk ("proposed standards"). FEI is a leading international organization of senior financial executives. CCR is the senior technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI or its members individually.

We believe the proposed standards accomplish the PCAOB's objective of establishing appropriate foundational principles on which future auditing standards can be based. We agree with the Public Oversight Board's Panel on Audit Effectiveness recommendation that "the audit risk model is appropriate, but needs enhancing and updating." A quality audit conducted within a reasonable amount of time and using a rational amount of resources, must be driven by risk assessments that direct the auditor's allocation of effort toward the areas of greatest risk.

Furthermore, we applaud the PCAOB's efforts to improve the requirements related to risk assessment such that they enhance the integration of the audit of the financial statements together with the audit of internal control over financial reporting. This is in alignment with the goal of improving the effectiveness and efficiency of the integrated audits.

The proposed standards include the statement "The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk." To ensure integrated audits of financial statements are of sufficient quality, we strongly agree that the Board's standards governing risk assessments need to contain the statement. However, taken by itself, this powerful statement could be misinterpreted to be inconsistent with an appropriately integrated audit. Accordingly, we suggest the Board add a note to this paragraph that explains why the requirements outlined in this paragraph must be true for a quality integrated audit to be conducted.

Similarly, we trust that the proposed standards will also be explicitly incorporated into the PCAOB's inspection process so as to ensure that auditors are truly implementing the guidelines for an integrated audit. As preparers of financial statements subject to audit under the PCAOB guidelines, one of our concerns is that the principles and objectives of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements (*"AS5") directed towards the achievement of quality, integrated audits are not applied consistently in practice. More specifically, we have concern that at times auditors spend too much time on inconsequential or lower risk areas and conversely do not spend as much time on higher risk, more complicated areas as they should. Accordingly, we believe that such concern could be mitigated and the objectives of AS5 and these proposed standards met if the requirements of the proposed standards be explicitly incorporated into the PCAOB inspection process.

The attachment that follows contains several other less significant suggestions for improvement.

We appreciate the PCAOB's consideration of these matters and welcome the opportunity to discuss any questions you have with respect to our comments.

Sincerely,

Arnold Hanish

Arnold C. Hanish
Chairman, Committee on Corporate Reporting
Financial Executives International

ADDITIONAL COMMENTS ON PROPOSED AUDITING STANDARDS RELATED TO THE AUDITOR'S ASSESSMENT AND RESPONSE TO RISK

We believe there could be enhancements to the proposed standards that would support the PCAOB's goal of improving the effectiveness and efficiency of the integrated audit. We have limited our comments to the following three standards:

- Identifying and Assessing Risks of Material Misstatements
- The Auditor's Responses to the Risks of Material Misstatement
- Consideration of Materiality in Planning and Performing an Audit

Identifying and Assessing Risks of Material Misstatements

We appreciate that the proposed standard is more specific in nature as it should create more consistency in the performance of financial statement audits as well as audits of internal controls by audit firms. This should also allow for more consistent measurement of the audit firms by the PCAOB. However, there are several areas in the proposed standard where we believe more specific verbiage should be considered:

- The standard includes factors and procedures an auditor should consider as part of obtaining an understanding of the company and its environment. We agree the items listed should be considered for all audits. The risk, however, with stating this as a "requirement" is that auditors will approach this as a "check-list" and the substance intended to be gained from such review will not be realized. We are concerned that the standard does not go far enough to connect the level of risk assessment to the substantive audit procedures that need to be performed. To truly ensure an effective and efficient audit, we believe auditors need to be very specific in determining how their time is allocated based on the risk assessment to prevent too much time on low risk accounts and not enough time on high risk accounts.

- We agree with the PCAOB's objective to write the proposed standard primarily from the integrated audit perspective. However, we believe that the note supplementing paragraph 34 seems to contradict the goal of one risk assessment being used for both the audit of the financial statements and the audit of internal controls. More specifically, we do not understand why a broader range of accounts and disclosures needs to be reviewed for the purpose of evaluating the effectiveness of internal control over financial reporting than what is necessary for an audit of financial statements only. Paragraph 7 of the Proposed Standard of Identifying and Assessing Risks of Material Misstatements explicitly states that the risks and risk assessment procedures should be the same for both types of audits.

The Auditor's Responses to the Risks of Material Misstatement

We agree with the proposed standard's guidance on auditor's responses to the risks of material misstatement. However, we believe the standard should include reference to the auditor's ability to use the work of others to obtain evidence about the design and operating effectiveness of controls as stated in AS5.

Consideration of Materiality in Planning and Performing an Audit
We agree with the proposed standard's guidance on establishing a lower materiality level or levels for particular accounts or disclosures, and appreciate the examples listed in the additional discussion of situations in which a lower materiality threshold might be needed. However, we believe the standard could provide additional clarity in the application of materiality in the following areas:

- We recommend that the proposed standard further define how an auditor should determine materiality of an uncorrected misstatement, with the intent of achieving a much greater degree of consistency and reliability of the financial statements being audited. One could argue that the variations in how auditors apply judgment to this metric do not provide consistency to financial statement users.

- Paragraph 5 states, when planning the audit, the auditor's materiality level for the financial statements as a whole be expressed as a specified amount. We believe this statement could also apply to paragraph 7 when assessing materiality for particular high risk accounts or disclosures.

Grant Thornton

February 18, 2009

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Audit – Tax – Advisory

Grant Thornton LLP
175 W Jackson Boulevard, 20th Floor
Chicago, IL 60604-2687

T 312.856.0200
F 312 565 4719
www.GrantThornton.com

Re: PCAOB Rulemaking Docket Matter No. 026, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Conforming Amendments to PCAOB Standards*

Dear Board Members and Staff:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("Board" or "PCAOB") *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Conforming Amendments to PCAOB Standards.* We support the Board's objective to update the auditing standards regarding risk assessment. As a member of the Center for Audit Quality (CAQ), we participated in the development of the CAQ's letter of comment in response to the Boards proposed risk assessment standards. We support the comments in the CAQ's letter and therefore, we have minimized repeating the same comments herein. We respectfully submit our comments and recommendations below.

Convergence of auditing standards

We were pleased to see that the Board considered the work of other standards setters in these proposals, and we found the analysis of significant differences in requirements between the Board's proposed standards and those of the corresponding International Standards on Auditing (ISA) to be very helpful. However, with the elimination of the application and other explanatory material and the various changes in terminology, we believe the Board has introduced inefficiencies into the process of understanding and applying the standards of the PCAOB, making it more difficult for an auditor to perform an effective and efficient audit under PCAOB standards, particularly with respect to multi-location engagements with foreign subsidiaries.

Within the Release, the Board states "Rather than including a significant amount of application material in the proposed standards, the Board reviewed the application and other material in the ISAs, adapted those provisions that the Board believed are necessary for audits of issuers, and included them in the proposed standards themselves." Under the ISAs, the application and other explanatory material is deemed to be essential in understanding the objectives and the proper application of the requirements. We believe this to be true. As we were reviewing the proposed standards, in some circumstances, our understanding of the requirements was based on our knowledge of the related application material in the ISAs. Although we agree with the Board's assessment that the concepts underpinning the proposed standards should be familiar to most auditors, we also believe PCAOB standards should be autonomous.

In addition, whenever two boards choose different words to address the same concepts, auditors need to consider whether the boards' intents are different, or only the words are different. Where the Board changed the active requirement (such as should consider to should assess), auditors need to understand whether the Board intends the auditor's responsibilities and actions, including those related to documentation, to be different than those under the ISAs. Accordingly, the Board's intent should be either clearly indicated in the analysis of significant differences or explained with additional guidance in the proposed standards.

However, we believe the Board should thoroughly consider the feasibility of taking an entirely different approach to its standard-setting process. Because the PCAOB is an active observer and participant in the International Auditing and Assurance Standards Board's (IAASB) standard-setting process, we believe the PCAOB should adopt the ISAs as a base. In doing so, PCAOB standards can be focused on the incremental requirements that would be necessary for audits of issuers.

This approach has been adopted by the U.S. Government Accountability Office for audits performed under *Government Auditing Standards*, and we believe it is a suitable approach for the PCAOB. Not only will this approach ensure consistency with the ISAs and convergence with other standard setters, it will allow the Board to focus its attention on establishing standards based on issues specifically related to issuers, in lieu of adapting provisions and modifying terminology. By leveraging the resources of other standards setters, we also believe the approach will allow the PCAOB to set standards more timely. Finally, although we believe the comments of the PCAOB observer are taken quite seriously at the IAASB, the PCAOB observer's comments would have even more credibility. This might increase the influence of the PCAOB at the IAASB, resulting in PCAOB standards requiring fewer amendments, greater convergence between the two sets of standards, and the elimination of inefficiencies from the processes of setting, understanding, and applying the standards.

Alignment of the proposals with Auditing Standard 5

We understand that one goal of this proposal is to improve the risk assessment process to enhance integration of the audit of the financial statements with the audit of internal control over financial reporting. We recognize that certain foundational risk assessment principles from Auditing Standard (AS) 5, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements*, were included in the proposal. However, we believe the delineation of these principles in both AS 5 and the proposed risk assessment standards has introduced some inconsistencies and redundancies. For example, the proposal inappropriately excludes the role of risk assessment, scaling the audit, and using a top-down approach, which are currently described in AS 5 and are applicable to all audits. Other examples of these types of matters are provided in the CAQ letter.

We believe it would be beneficial to have one standard (or set of standards) dealing with the risk assessment process that is the same for all audits (integrated and financial statement only), and another standard focusing only on the additional requirements in an integrated audit that are specific to achieving the objectives related to the audit of internal control over financial reporting. This structure would (1) more clearly demonstrate the integration of the risk assessment process in an integrated audit, and (2) reduce inconsistencies and redundancies within PCAOB standards. Accordingly, we believe AS 5 requires significant amendment to reflect the risk assessment standards for the Board's proposal to be successful.

Appendix 1: Audit Risk in an Audit of Financial Statements

In reference to our previous comments on aligning the proposed standards with AS 5, we believe proposed *Audit Risk in an Audit of Financial Statements* (Appendix 1) should incorporate the risk assessment concepts in AS 5.

The objective of the auditor in this standard "to conduct the audit of the financial statements in a manner that reduces audit risk to an appropriately low level" relates to the overall objective of the auditor and is not specific to the subject of this standard, which is the auditor's consideration of risk assessments. Furthermore, this standard does not propose any requirements that would enable the auditor to meet the objective. In fact, the only "should" in the standard is in the context of a reference to a requirement that is set in another standard. The Board could take one of several approaches to aligning the requirements and the objective of this standard:

- Revise this standard along the lines of ISA 200 (Revised and Redrafted), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, including the objective as the overall objective of the auditor and including a discussion of the relationship between that objective and the objectives in each of the standards. This is the approach we support.

- Incorporate the discussion of audit risk in Appendix 1 of the proposed standard as introductory material to proposed *Identifying and Assessing the Risks of Material Misstatement*.

- Publish the content of Appendix 1 as background material to the standards as a whole, without an objective or requirements.

Appendix 2: Audit Planning and Supervision

With respect to proposed *Audit Planning and Supervision*, we have the following observations in addition to those in the CAQ letter:

- In paragraph 6b, we suggest the Board include a reference to Rule 3526, *Communication with Audit Committees Concerning Independence*, as this Rule is important with respect to compliance with independence and ethics requirements.

- Although we understand the intent of the second sentence in paragraph 17, some may interpret it to mean that obtaining sufficient appropriate evidence regarding opening balances is optional. We suggest the Board restructure this paragraph similar to paragraph

A21 of ISA 300, *Planning an Audit of Financial Statements*. At a minimum, we believe the sentence should be split to separate the requirement from the example.

In reference to the Board's questions, we do not believe additional direction is needed with respect to multi-location engagements. However, we are concerned with having similar guidance, covering the same topic, in two places within the body of the standards. Since most of the multi-location guidance in AS 5 also applies in an audit of financial statements, we suggest incorporating the guidance from AS 5 into this proposed standard. In AS 5, we suggest a reference to the guidance in the proposed standard and, if appropriate, additional guidance that is specific to the internal control audit, including how the auditor should use that guidance in combination with the guidance in the proposed standard.

Appendix 3: Identifying and Assessing Risks of Material Misstatement

We believe proposed *Identifying and Assessing Risks of Material Misstatement* contains certain inconsistencies with AS 5; for example, as mentioned above, the role of risk assessment and scaling the audit (AS 5, paragraphs 10-13) and using a top-down approach (AS 5, paragraph 21) are inappropriately excluded from the risk assessment standards. Such inconsistencies may cause the auditor to diverge from an integrated audit approach because they suggest different, rather than incremental responsibilities. This supports our previous comment to amend AS 5 and incorporate the relevant concepts in the risk assessment standards.

We also have the following additional observations:

- The objective in the proposed standard is not outcome based. It simply states the auditor's objective is it to identify and appropriately assess risks, without including the purpose for which this is to be performed. Under the ISAs, the identification and assessment of risks provides a basis for designing and implementing responses to the assessed risks.

- Paragraph 24 could be rewritten to more clearly state that management may use an internal control framework that differs from the components identified in paragraph 23 when establishing and maintaining the company's internal control over financial reporting. In evaluating the design of controls and determining whether they have been implemented in a financial statement only audit, the auditor may use the framework used by management or another suitable, recognized framework.

- In paragraph 56f, the phrase "without regard to the effect of controls" can be deleted, as the definition of inherent risk in paragraph 7 of Appendix 1 includes this concept in the phrase "before consideration of any related controls." In other words, the phrase is redundant with the definition of inherent risk.

- The proposal lacks guidance on how to identify and assess the risks of material misstatement at the financial statement level. We suggest the Board include additional guidance similar to that included in paragraphs A98-A101 of ISA 315 (Redrafted), *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment*.

In reference to the Board's questions, specific requirements and direction on documentation are not necessary. The Board's standards should remain principles based. Equivalent requirements in comparison to the ISAs would be acceptable.

Appendix 4: The Auditor's Responses to the Risks of Material Misstatement

Overall, we believe proposed *The Auditor's Responses to the Risks of Material Misstatement* clearly describes the auditor's responsibilities in response to risks of material misstatement, and we have no additional comments other than those expressed in the CAQ letter.

Appendix 5: Evaluating Audit Results

Proposed *Evaluating Audit Results* is a conglomeration of various requirements pertaining to the evaluation of audit results. Although we believe it is appropriate to include such requirements in one standard, the objectives of the auditor would need to address each of the specific objectives that would have been included if the requirements were in separate standards. In this regard, we believe the PCAOB has created a standard that may be perceived as weaker than the ISAs.

In addition, we believe the PCAOB has also made requirements that were quite clear under the ISAs ambiguous under PCAOB standards. More specifically, we provide the following observations that are, for the most part, addressed in more detail by the CAQ letter:

- It should be clear that analytical procedures in the overall review of the financial statements are similar to analytical procedures performed as risk assessment procedures (paragraph 8). This would clarify the fact that the results of such analytical procedures may identify a previously unrecognized risk of material misstatement requiring revision of the auditor's risk assessment and modification of further planned audit procedures.

- There are several different phrases used to describe unusual or unexpected trends, transactions, amounts and relationships that should be reconsidered (paragraphs 7, 9-11). We believe the Board should use the same phrase to describe this set of factors wherever it is referred to.

- The term identified misstatements is inappropriately used (paragraph 14). We believe this term intends to include known or factual misstatements. However, the auditor may identify such misstatements, as well as potential or likely misstatements. Clear delineation is needed with respect to known or factual and potential or likely misstatements.

- The requirement to evaluate uncorrected misstatements related to the prior year does not appropriately reflect Staff Accounting Bulletin (SAB) 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (paragraph 19). The ISAs were written to be framework neutral on this point; however, we believe PCAOB standards should appropriately reflect the requirements in this SAB. However, the ISAs are clearer in that misstatements detected in the current year could be related to the prior year.

- Additional guidance on the indicators of management bias and their effect on the audit, and the auditor's responsibility to assess bias is necessary (paragraphs 25 and 29). Although these requirements stem from requirements in the ISAs, we believe this is an audit area that requires additional context. The Board should consider incorporating the guidance in paragraphs A1 to A3 of ISA 700, *Forming an Opinion and Reporting on Financial Statements.*

- The requirement pertaining to differences in accounting estimates is inadequate as it relates to determining whether a misstatement exists (paragraph 28). The requirement itself seems to relate to whether a misstatement exists in an accounting estimate and does not seem to belong in the section entitled "Assessing Bias in Accounting Estimates." We believe this requirement should be included in the section entitled "Accumulating and Evaluating Identified Misstatements." We also believe additional guidance is needed with respect to the difference between point estimates and ranges of estimates (paragraphs A116 to A119 of ISA 540 (Revised and Redrafted), *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*).

Appendix 6: Consideration of Materiality in Planning and Performing an Audit

Except with respect to the use of the terms "reasonable investor" and "tolerable misstatement," we believe proposed *Consideration of Materiality in Planning and Performing an Audit* is clear regarding the auditor's responsibility to apply the concept of materiality in planning and performing an audit, including establishing lower materiality levels for particular accounts or disclosures. We believe the Board should:

- Reconsider the use of the term reasonable investor. This term is inconsistent with existing PCAOB standards (AS 5, paragraph 91) and ISA 320 (Revised and Redrafted), *Materiality in Planning and Performing an Audit* (paragraph 10), which use the term "user." We believe the term user is more appropriate when discussing materiality.

- Use the term performance materiality in lieu of tolerable misstatement to be consistent with the ISAs (ISA 320, paragraph 12). In the ISAs, tolerable misstatement is limited to audit sampling and is separately defined. We believe unnecessary differences in terms used by different standards setters to describe the same concepts should be eliminated.

Appendix 7: Audit Evidence

For the most part, we believe proposed *Audit Evidence* clearly describes the principles necessary for evaluating the sufficiency, relevance, and reliability of audit evidence. However, the standard itself establishes requirements and provides direction with respect to designing and performing audit procedures to obtain sufficient appropriate audit evidence. To achieve the objective in this proposed standard, which seems to relate to audit evidence obtained during the entire audit, the Board would need to establish requirements similar to those in ISA 200. Essentially, this objective is a requirement in ISA 200 that is necessary to achieve the overall objectives of the auditor. In this regard, the Board should align the objective with the objective in ISA 500 (Redrafted), *Audit Evidence*. We believe this would be consistent with the scope of the proposed standard described in paragraph 1.

We further believe the five categories of assertions are sufficient and do not need to be expanded. However, we also see no need to diverge from the ISAs. In addition, paragraph 12 implies that different assertions could be used based on whether the auditor is performing a financial statement only audit or an integrated audit. We believe the assertions in both cases would be the same, as is the auditor's risk assessment. What differs is the auditor's procedures to achieve the objectives of a financial statement only audit or an integrated audit. Again, this would also require revision of AS 5.

We would be pleased to discuss our comments with you. If you have any questions, please contact Mr. John L. Archambault, National Managing Partner of Professional Standards, at (312) 602-8701.

Sincerely,

Grant Thornton LLP

ILLINOIS CPA SOCIETY

February 18, 2009

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington D.C. 20006-2803

Ref: PCAOB Rulemaking Docket Matter No. 026

To Whom It May Concern:

The Audit and Assurance Services Committee of the Illinois CPA Society ("Committee") is pleased to comment on the Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards.

The Committee is a voluntary group of CPAs from public practice, industry, education, and government. Our comments represent the collective views of the Committee members and not the individual views of the members or the organizations with which they are affiliated. The organization and operating procedures of our Committee are outlined in Appendix A to this letter.

Following are the Committee's comments regarding specific items included in the proposed standards. The Committee considered the questions included in Appendix 9 in the Proposed Standards in developing our comments.

<u>Audit Planning and Supervision</u>

1. Paragraph 5 indicates:

   > "The engagement partner is responsible for planning the engagement but may seek assistance from other members of the engagement team."

   This paragraph seems to indicate that the engagement partner can plan the audit *without* involvement of other key members of the engagement team. It would seem appropriate to require that all key members of the engagement team (e.g. managers and seniors) are involved in the planning process and that the engagement partner must be actively involved in and assume overall responsibility for the planning process. It may also be appropriate to encourage, but not require, the involvement of specialists (e.g. IT specialists) throughout the audit planning process.

2. The note at the end of Paragraph 6 implies that the understanding with the client regarding the services to be performed on the engagement cannot change with changes in circumstances. There may be certain circumstances that may require changes to the services to be performed on the engagement.

3. In Paragraph 7, the last bullet point "The relative complexity of the company's operations" seems repetitive – the third bullet indicates that the auditor should evaluate the company's "operating characteristics".

4. In paragraph 7, should the auditor also consider adjustments proposed (recorded or unrecorded) to prior years' financial statements?

Identifying and Assessing Risks of Material Misstatement

1. In paragraph 13, the first bullet point refers to "public information" that is "relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of internal control over financial reporting". It would be helpful to provide some specific examples of the appropriate "public information" to be obtained and considered by the auditor.

2. Only some of the additional procedures in paragraph 13 are reasonable and appropriate. Reading publicly available information about the company, observing or reading transcripts of earnings calls, and obtaining an understanding of compensation arrangements are all procedures that most auditors should consider performing in connection with their audits and specifically requiring these procedures for all audits would likely not result in significant changes to most audit approaches. However, requiring a consideration of "obtaining information about significant unusual developments regarding trading activity in the company's securities" is rather vague and seems to place undue burden on the auditor to consider performing additional procedures related to an area in which the auditor lacks the proper resources or expertise to effectively complete such procedures. Any unusual activity should be discovered and investigated by the appropriate regulatory authority, not the auditor. Additional clarification related to the auditor's responsibilities in regard to obtaining information in regard to trading activity should be provided or the requirement to consider this item should be removed from the proposed standard.

3. Paragraph 46 discusses the key engagement team members that should be included in the discussion among engagement team members regarding risks of material misstatement. The proposed standards should also encourage, but not require, the involvement of specialists (e.g. IT specialists) in this discussion.

The Auditor's Responses to the Risks of Material Misstatement

1. Paragraph 45 seems to indicate that tests of details are required when performing substantive procedures in connection with responding to significant risks by

indicating "for significant risks, the auditor should perform substantive procedures, including tests of details that are specifically responsive to the risks". Existing standards (AU sec. 329.09) indicate that substantive analytical procedures alone would <u>likely not be sufficient</u> responses to significant risks, but do not explicitly require tests of details. The auditor should have the ability to exercise professional judgment in the determination of the substantive testing approach to be used to respond to significant risks. Although tests of details would and should ordinarily be performed in connection with responding to significant risks, there may be situations for which substantive analytical procedures alone would be sufficient (in the auditor's professional judgment) to respond to significant risks. The proposed standard should be updated to be consistent with the existing standard by indicating that substantive analytical procedures alone would <u>likely not be sufficient</u> responses to significant risks.

<u>Evaluating Audit Results</u>

1. Paragraphs 5a and 6 refer to a process called "overall review" in the context of evaluating the results and sufficiency of applied analytical procedures. The scope of the "overall review" is not sufficiently developed or explained in order to determine whether these procedures are incremental to those planned and applied in the audit of the financial statements. Further, this section provides little guidance on why it has singled out analytical procedures related to revenue in paragraph 8 as a required component of this undefined effort.

2. Paragraph 13 allows the auditor to designate a de minimis amount below which misstatements are clearly trivial and do not need to be accumulated. Paragraph 14 provides further guidance that infers that this amount should be applied to misstatements in the actual accounts and the financial statement disclosures. Without further guidance, it could be difficult to apply a quantitative de minimis threshold to potential misstatements of disclosure. We would request further clarification of the intent of the de minimis threshold related to potential disclosure misstatements.

3. Paragraph 15a refers to analysis and accumulation of misstatements which could be deemed to be material. Paragraph 5 indicates that this risk assessment relates only to the financial statement portion of the integrated audit. However, any conclusion made on materiality with respect to adjustments need to consider the evaluation around a material weakness in internal control over financial reporting.

4. Paragraph 19 indicates that the effects of uncorrected misstatements detected in prior years need to be considered in the evaluation of the financial statements as a whole. However, there is not guidance on how that consideration should be applied. Other sections of this Exposure Draft refer to SEC guidance when applicable. If the intent of this consideration was to include the guidance provided in SAB 108, it should be so referenced herein.

5. Paragraph 25 refers to the qualitative aspects associated with the company's accounting "practices." The phrase "practices" can be construed to mean a lot of things in addition to accounting policies. The intent should be clarified to refer specifically to policies unless there is a broader reference was intended.

6. In paragraphs 25-29, there is no reference to communication or dialogue with the company's lead corporate governance committee of the board of directors, presumably the audit committee. A dialogue with the company's audit committee around acceptable accounting policies is required and a critical part of the evaluation.

7. Paragraphs 30-32 are somewhat redundant to each other. The concept is essentially whether there has been appropriate consideration of fraud risks throughout and at the completion of the audit.

8. In paragraph 36b, it is unclear what the content of the audit procedures performed represents. A reading of the passage, without additional context, could be construed to refer to the entirety of the audit files on a particular engagement. If the reading is correct, this passage simply says that all audit work must be considered in the evaluation of the sufficiency and scope of audit evidence. This type of statement would be more applicable in a description of the proposed standard rather than one factor designed to achieve a relevant conclusion.

9. Paragraphs 39 and 40 imply that the audit of internal control is a somewhat parallel process to financial statement audit. Rather, as envisioned by AS 5, these audits are traditionally (and preferably) done on an integrated basis. Seems awkward that a risk assessment designed to address a financial statement audit (see paragraph 5) would then have a separate consideration for the audit of internal control over financial reporting.

Audit Evidence

1. Paragraph 10 includes footnote that references AU sec. 336, *Using the Work of a Specialist*. May also consider adding a reference to AU Section 324, *Service Organizations*, as some information "produced" by the company may come from a service organization.

Proposed Conforming Amendments to PCAOB Standards

1. In AU Sec. 9326 "Evidential Matter" Auditing Interpretations of Section 326" we recommend that you modify your suggested change to the third and fourth sentences of paragraph .03 to maintain the theme of the other conforming amendments. Instead of stating "the kinds and competence of available evidential matter" we suggest the wording be modified to "the kinds and appropriateness of available evidential matter" since most references to the term competent has been replaced with appropriate.

2. In the suggested change to paragraph .80 of AU Sec. 316 "Consideration of Fraud in a Financial Statement Audit", the Board has replaced the prior wording with new wording discussing the absence of or deficiencies in controls that address fraud risks. We recommend the Board consider modifying its suggested wording from "represent significant deficiencies" to "represent significant deficiencies or material weaknesses". We believe that a lack of controls related to fraud could elevate to the level of a material weakness.

The Illinois CPA Society appreciates the opportunity to express its opinion on this matter. We would be pleased to discuss our comments in greater detail if requested.

Sincerely,

Jon R. Hoffmeister
Audit and Assurance Services Committee

APPENDIX A

ILLINOIS CPA SOCIETY
AUDIT AND ASSURANCE SERVICES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2008 – 2009

The Audit and Assurance Services Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to more than 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of audit and attestation standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of audit and attestation standards. The Subcommittee develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint.

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INSTITUT DER WIRTSCHAFTSPRÜFER

Institut der Wirtschaftsprüfer
in Deutschland e. V.

Wirtschaftsprüferhaus
Tersteegenstraße 14
40474 Düsseldorf
Postfach 32 05 80
40420 Düsseldorf

TELEFONZENTRALE:
+49 (0)2 11 / 45 61 - 0

FAX GESCHÄFTSLEITUNG:
+49 (0)2 11 / 454 10 97

INTERNET:
www.idw.de

E-MAIL:
info@idw.de

BANKVERBINDUNG:
Deutsche Bank AG Düsseldorf
BLZ 300 700 10
Kto.-Nr. 7480 213

Mr. Tom Ray
Chief Auditor
Public Company Accounting Oversight Board
c/o Office of the Secretary
1666 K Street, N.W.
Washington, D.C. 20006-2803
USA

By E-mail: comments@pcaob.org

February 18, 2009

Dear Tom,

Re.: PCAOB Rulemaking Docket Matter No. 026
PCAOB Release No. 2008-006, October 21, 2008
Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk
And Conforming Amendments to PCAOB Standards

We would like to thank you for the opportunity to comment on the PCAOB's Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk And Conforming Amendments to PCAOB Standards (hereinafter collectively referred to as the "proposed standards"). We are commenting on these proposed standards because they are directly relevant to the members of the German Wirtschaftsprüfer profession that audit the financial statements of SEC-registrants or their subsidiaries, and because PCAOB standards do influence standards setting elsewhere, including that of the International Auditing and Assurance Standards Board (IAASB).

We welcome the updating of the PCAOB's interim standards that deal with audit risk and introduce the "risk assessment" and "risk response" paradigm currently effective in the International Standards on Auditing (ISAs), in the AICPA Auditing Standards, and in many other standards throughout the world, including our IDW Auditing Standards. We particularly welcome the efforts made to align the

GESCHÄFTSFÜHRENDER VORSTAND:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands;
Dr. Klaus-Peter Feld, WP StB CPA;
Manfred Hamannt, RA

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proposed standards with the ISAs, because this furthers the overall objective of international convergence of auditing standards needed for international capital markets. As a matter of principle, we also welcome the introduction of objectives into the standards to act as a guide to the auditor in considering whether the application of the requirements has achieved the objective desired.

We also find favor with the 120 day comment period. We specifically support the comments made by Daniel L. Goelzer in relation to the need for further development of due process. Given the international significance of PCAOB standards, we believe that they require a transparent due process throughout their development.

We recognize that at this stage, in which the PCAOB has chosen not to exercise its mandate under Section 103 (a) 3 (A) (i) of the Sarbanes-Oxley Act to adopt other auditing standards, such as the ISAs, the PCAOB would issue auditing standards that contain some differences to the ISAs because the PCAOB's standards:

1. take into account U.S. securities laws and SEC and other PCAOB rulemaking in relation to these laws;
2. are written in the context of an integrated audit of the financial statements and of internal control over financial reporting, as opposed to only focusing on the audit of the financial statements,
3. are consistent with those PCAOB interim standards that have not yet been revised or updated and that represent counterparts to ISAs that have been revised by the IAASB in the last three or four years, and
4. do not include matters in the ISAs that are not applicable to audits of the financial statements of SEC-registrants.

However, we question the need for any differences between the ISAs and the proposed standards beyond these situations, and, based upon our reading of the proposed standards, surmise that the application of these situations has been interpreted too broadly.

The IAASB's auditing standards reflect the product of an intensively overseen and thorough due process involving considerable consultation at an international level, including input from regulators, such as the PCAOB. We believe that international convergence of auditing standards towards the ISAs is important for international capital markets. Consequently, although as national standards setters in Germany, there are issues that we believe that could be addressed, or addressed differently, in the ISAs, that could improve the ISAs, we would generally refrain from departing from the ISAs when we transpose these into national standards, unless situations in Germany that are analogous to the four identified above apply. For these reasons, we do not believe it to be conducive to international convergence of auditing standards for the PCAOB to write auditing standards that differ from the ISAs at a technical level for reasons other than those clearly related to the four situations noted above.

As the current financial crisis has shown only too clearly, the U.S. economy is not an isolated island. We therefore believe it to be in the long term interests of not only global capital markets, but also of the American capital market and its U.S. investors that auditing standards in the world converge towards a single set of high quality auditing standards, just like the world, including the U.S., at the present time appear to be converging towards one set of high quality financial reporting standards (IFRS) for publicly listed entities. To this effect, the ISAs are the most widely accepted benchmark of high quality auditing standards at an international level because of the IAASB's intensive and internationally oriented due process. Therefore, due to their impairment of international convergence of auditing standards, differences between the ISAs and the proposed standards not clearly justified by the four situations noted above should be minimized as far as possible.

Furthermore, differences between the ISAs and the proposed standards that cannot be avoided due to the four situations noted should be made as transparent as possible. This means that, to the extent possible, the placement (i.e. in which standards), structure (i.e. the order within a standard) and wording of the requirements in the proposed standards should be aligned as far as possible to ease comparison and reconciliation. We found it extremely difficult to compare the nature and extent of requirements in the proposed standards to the ISAs and our standards because the PCAOB chose to place some requirements in other standards than in those commensurate to the ISAs (e.g. many of the requirements in relation to fraud, which are included in the risk assessment and response proposed standards, rather than the fraud standard), ordered the requirements differently, and used different wording when using the same would have appeared to have been adequate. As a result, reconciling firm audit methodologies between the ISAs and the proposed standards may be a very difficult and costly exercise for the audit firms affected.

We also note the tendency of the proposed standards to include matters that are in the application material of the ISAs into lists of presumptively required procedures of the proposed standards. We are not convinced that creating further "checklists" of procedures to be done, whether or not they are relevant or significant, without further thought and application of professional judgment by the auditor will lead to a better audit: it will lead to precisely that kind of checklist mentality that is detrimental to a good quality audit. We therefore recommend that the PCAOB rethink its strategy on auditing standards to move towards a more top-down principles-based approach and to therefore consider removing some of these presumptive requirements and placing them into the accompanying explanatory material of matters that the auditor may consider in the circumstances.

In the enclosed Appendix to this comment letter, we have addressed a number of what, in our view, are the more important differences between the proposed standards and the ISAs that have come to our attention through the review of the proposed standards, that we believe need not be maintained in the proposed standards. The matters addressed do not represent all of the potential differences that we have identified. Furthermore, given the difficulties noted in comparing and reconciling the ISAs with the proposed standards, we cannot claim that we have identified all of the important differences, let alone all of the less important ones.

If you have any further questions about our comments, we would be pleased to discuss our comments with you.

Yours very truly,

Klaus-Peter Feld	Wolfgang Böhm
Executive Director	Director International Affairs

494/584

Appendix

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APPENDIX

Proposed Auditing Standard – Audit Risk in an Audit of Financial Statements

In the second sentence of paragraph 3, reference is made to "applying due professional care and obtaining sufficient appropriate audit evidence". In our view, due professional care and obtaining sufficient appropriate audit evidence are not separate issues: in the context of obtaining reasonable assurance, an auditor exercises due professional care only if he or she has obtained sufficient appropriate audit evidence. Consequently, we suggest changing the wording to read "exercising due professional care by obtaining sufficient appropriate audit evidence".

Proposed Auditing Standard – Audit Planning and Supervision

We find the inclusion of the requirement in paragraph three in the objectives section confusing: shouldn't the objectives section only include objectives?

Many of the issues addressed in paragraph 7 may be better placed in the risk assessment standard (as in the ISAs), rather than as part of planning, since these matters relate to the obtaining an understanding of the business aspect of risk assessment.

The references in paragraphs 14 and 15 to individuals needed for specialized skill or knowledge in relation to IT appear to us to be an attempt to incorporate thoughts from the revised ISA 620 into the proposed planning standard. Furthermore, it places undue emphasis on specialized IT skills compared to other specialist skills that may be needed for the audit. For this reason, we suggest that the proposed planning standard not address these issues, but that these issues be addressed as part of a standard on using the work of specialists generally, and not necessarily in the requirements.

INSTITUT DER WIRTSCHAFTSPRÜFER

Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement

We do not understand the reason for the objective to be different than that expressed in ISA 315.03, which is more precise. We suggest that the proposed standard be revised to align the objective with that in ISA 315.

The use of the words "should consider" in paragraph 13 will have the effect of requiring the auditor to justify for each bullet point why a certain procedure was not performed, rather than having auditors take a top-down approach to determining which audit procedures they ought to be performing in the circumstances. This leads to a checklist approach to the issues identified, which is not conducive to audit quality.

We are concerned with the list of presumptive requirements in paragraph 19, which includes the words "if applicable". If a matter is not generally applicable, it should not be included as a presumptive requirement, but in additional explanatory material. This list will cause auditors to have to justify in each case why something is or is not applicable and therefore lead to a checklist mentality on the audit, which is not conducive to audit quality.

Paragraph 20 states that the auditor should obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that effect the risks of material misstatement and (c) design further audit procedures. We have a number of difficulties with this requirement. First, we would like to point out that, unless the auditor does a combined inherent risk and control risk assessment (a misstatement risk assessment), an auditor identifies types of potential misstatements by examining inherent risks without including the effect of control risk. This is in fact required by the ISA 315.26 for significant risks. Second, some components of internal control only affect the misstatement risk at the financial statement, rather than assertion, level. Consequently, obtaining an understanding of these components will not lead to the ability to identify types of potential misstatements, which is an assertion-level concept. Third, the only factors that affect the risks of material misstatement are inherent and control risk: does this mean that by requiring an assessment of the factors that effect the risks of material misstatement, the PCAOB is requiring a separate, rather than combined, risk assessment, for all cases, including risks that are not significant risks? This seems to be at odds with other requirements in the standards. Furthermore, what is now left (sufficient understanding of internal control to design further audit procedures) would have been covered by the objective of the standard if the objective used in ISA 315.03 had been applied. It is therefore redun-

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dant. On the whole, therefore, there is no need for this requirement, which only confuses a number of issues and therefore causes more harm than good.

Paragraph 38 of the proposed standard specifically requires the auditor to incorporate knowledge obtained in past audits in the risk assessment of subsequent audits. The ISAs (see ISA 315.09) are more cautious in this regard because the real issue for auditors is whether this information is still relevant. We suggest that the PCAOB consider being more cautious on this issue by aligning its requirement with that of ISA 315.09.

Paragraph 41 states that the "auditor should assess" whether information gained from other engagements performed by the auditor is likely to be important for identifying risks. There are two issues of concern here. First, the word "auditor" could mean the audit firm. It is unlikely that audit firms will be in a position to convey only relevant information from one team performing an unrelated non-assurance engagement at the company to another performing the audit without developing very costly reporting systems between engagement teams; there may even be confidentiality barriers. The ISAs resolve this problem by addressing the engagement partner only. Second, even if the engagement partner becomes privy to information from another completely unrelated engagement, the engagement partner need not "assess" the relevance of that information, but need only consider whether it may be relevant at that stage. An "assessment" involves a detailed evaluation process, as opposed to a "consideration", which involves thought on the part of the engagement partner. We suggest that the proposed standard be aligned to the ISAs.

The use of the phrase "analytical procedures designed to" in paragraph 42 suggests that such analytical procedures are more effective than they actually are in covering items (a) and (b). As pointed out in the ISAs (ISA 315.6(b) together with ISA 315.A7), analytical procedures contribute to an auditor's understanding of (a) and (b), but only in conjunction with other procedures.

It seems to us that the requirement in paragraph 46 provides a gratuitous definition of who "key engagement members" are without adding any real guidance because it interprets the word "key" by using the term "significant engagement responsibilities", which is not particularly helpful. Furthermore, one would presume that the discussion would cover only important matters, which makes the following requirement to communicate important matters to the other engagement team members too restrictive. On the other hand, it begs the question of "important to whom"? The solution in ISA 315.10.02 is more practical in that the engagement partner makes the determination of what needs to be reported to whom on a "need to know" basis.

Paragraph 48 represents a rules-based approach to audits by including a "checklist" of matters that should be covered in the discussion among team members about potential misstatements due to fraud. Not all of these matters may be relevant on all audits, and there may be matters that are relevant that are not on the list (see ISA 240.A11). We therefore suggest that the PCAOB consider whether guidance on this matter may be more helpful than a list of requirements.

Paragraph 49 requires specific communication of items that are required of auditors on all audits. This is a rather strange and even redundant requirement. Once having communicated these matters to all audit staff at a firm, why would they need to be communicated again on every engagement? This is a matter that ought to be addressed as part of the fraud standard in terms of the overall stance taken by team members on all audits, not as part of risk assessment for each audit.

Paragraph 50 contains the requirement that auditors make inquiries of those within the company that "might reasonable be expected to have information". This is a very open-ended requirement that begs the question, "reasonably expected by whom? The auditor? The PCAOB? The courts? From our point of view, with hindsight any third party will always be able to claim that the auditor should have made an inquiry of someone that he hadn't. In our view, as described in ISA 315.06(a), it is the auditor's judgment that is paramount in this situation: no one else was there at the time and there shouldn't be any second-guessing with hindsight unless the auditor's judgment was clearly unreasonable in the circumstances.

Paragraph 52 d addresses inquiries of accounting and financial reporting personnel. This is also a very open-ended requirement, because auditors would then need to perform all of the procedures in (1) to (4) for all such personnel, which is clearly unreasonable. Furthermore, such a procedure may not always be effective, depending upon the position and nature of the individual. In our view, this matter is a procedure that the auditor may wish to consider in appropriate circumstances, but not one that should be done all of the time. We therefore suggest that this requirement be replaced by guidance.

Paragraph 54 contains the requirement that auditors make inquiries of those within the company that "might reasonable be expected to have information". This is a very open-ended requirement that begs the question, "reasonably expected by whom? The auditor? The PCAOB? The courts? From our point of view, with hindsight any third party will always be able to claim that the auditor should have made an inquiry of someone that he hadn't. In our view, as described in ISA 315.06(a), it is the auditor's judgment that is paramount in this situation: no one else was there at the time and there shouldn't be any second-guessing with hindsight unless the auditor's judgment was clearly unreasonable in the circumstances.

Proposed Auditing Standard – The Auditor's Response to the Risks of Material Misstatement

We do not understand why the objective in paragraph 3 of the proposed standard needs to depart from the very precisely worded objective used in ISA 330.03. We suggest that the wording in the proposed standard be aligned to that in the ISAs.

We note that the objectives and the requirements relate to responses to the risks of material misstatement, rather than to the assessed risks of material misstatement. We do not find the explanation on Pages A10-4 to A10-5 to be convincing. We would like to point out that an auditor obtains reasonable – not absolute – assurance. This means that even if an auditor has performed an appropriate risk assessment in compliance with PCAOB auditing standards, the actual risks may be significantly different from those assessed. However, an auditor can only respond to the assessed risks – not to the actual risks, which are unknown. If an auditor's inappropriate assessment of risks that is not in compliance with PCAOB auditing standards leads to appropriate responses to inappropriately assessed audit risks, then the noncompliance with PCAOB auditing standards relates to the inappropriate assessment, not the appropriate response to the inappropriate assessment. By requiring an appropriate response to actual misstatement risks, rather than to those assessed, the PCAOB is setting a standard that is impossible to meet in practice or theory.

We believe that it is important for auditors to implement overall responses to risks at the financial statement level because these risks are pervasive to the financial statements: they would be difficult to address only at the assertion level. For this reason, we do not share the view of the PCAOB that an auditor need not match overall responses to misstatement risks at the financial statement level. Such a requirement does not lead to the auditor being able to avoid performing audit procedures to address risks of material misstatement at the assertion level at all and therefore such a requirement ought to be included in the proposed standard.

We are concerned with the requirement for substantive tests of details for all relevant assertions for significant accounts or disclosures, and for all significant risks. We would like to point out that in some cases, performing substantive tests of details rather than, or in addition to, tests of control and analytical review procedures may not obtain any additional assurance because the tests of detail may not be relevant. For example, for some cases, as identified in ISA 315.29, for risks for which substantive procedures alone do not provide sufficient appropriate audit evidence (e.g. the completeness assertion or some fraud risks), substantive tests of details may be irrelevant. For this reason, we believe that the requirement to perform such substantive tests of detail for all relevant assertions, as described in paragraph 40 of the proposed standards is inappropriate and needs to be deleted. Likewise the requirement for substantive tests of details for all significant risks in paragraph 45 is inappropriate and should be deleted.

The requirement in paragraph 49 to compare relevant information about the account balance at the interim date with comparable information at the period end presumes that there will always be comparable information. In our view, requirements should not be introduced for situations that may or may not exist on most audits, unless there is an overriding need for a requirement predicated upon such existence, even if it is rare. We do not see such an overriding need when auditors are already required to test the remaining period.

Proposed Auditing Standard – Consideration of Materiality in Planning and Performing an Audit

We believe that this proposed standard would benefit from a discussion of materiality by at least conveying the discussion of materiality from the appropriate FASB standards or concept statements and the description provided by the courts. Furthermore, the proposed standard would greatly benefit from the matters discussed in ISA 320.04, which forms the basis for an auditor's consideration of materiality and does not appear to be inconsistent with the concept of a reasonable investor under U.S. securities law.

We note that the proposed standard uses the term "tolerable misstatement" from AU §350 *Audit Sampling* rather than the term "performance materiality" used in the ISAs. This would be appropriate if "tolerable misstatement" as defined in AU §350 is the same as the meaning of tolerable misstatement in the proposed standard. However, we would like to point out that the two concepts are equivalent for a particular financial statement item only when sampling the entire population of items comprising that financial statement item (i.e. one could select particular items included in that financial statement item for testing and draw a statistical sample for testing on the remaining items). When sam-

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pling less than all of the population of items comprising a financial statement item, "tolerable misstatement" for statistical purposes for the sampled population (which would be a portion of the total population of the financial statement item) would be different than the "tolerable misstatement" applied to that entire financial statement item (which may or may not be the same as the "tolerable misstatement" for the financial statements as a whole) to reduce to an appropriately low level the risk that the aggregate of uncorrected and undetected misstatements in that item exceeds the materiality for that item (which may or may not be the same as the materiality for the financial statements as a whole). For these reasons, we question whether it is appropriate to use the same terms for statistical sampling and for reducing to an appropriately low level the risk that the aggregate of uncorrected and undetected misstatements in an item exceeds materiality for that item.

International Federation of Accountants
545 Fifth Avenue, 14th Floor, New York, NY 10017 USA
Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

February 18, 2009

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington D.C. 20006-2803

By email: comments@pcaobus.org

Dear Sir/Madam,

RE: PCAOB Rulemaking Docket Matter No. 2008-02–Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk

Staff of the International Auditing and Assurance Standards Board ("IAASB") would like to congratulate the Public Company Accounting Oversight Board ("the Board") on achieving a significant milestone with the completion of a comprehensive revision of its risk assessment standards. This is a significant step forward in terms of the Board's work on amending and replacing its interim standards. The proper identification and assessment of, and response to, risks by the auditor lay the foundation for a high quality audit. Accordingly, we note the importance of this task and the enormity of the efforts put in by the Board and its technical staff in developing these proposed standards.

We are encouraged by the Board's use of the IAASB's International Standards on Auditing ("ISAs") in developing the proposed standards and commend the Board's objective to eliminate unnecessary differences between the two set of standards. We believe this is an important and positive step towards increasing the comparability of audits internationally and creates a common basis on which auditors conduct audits, thereby enhancing the consistency of practice in the public interest. We believe this also sets a good example of leveraging the efforts of other audit standard-setting bodies towards timely development of high quality auditing standards.

We would also like to take this opportunity to commend the Board on its analyses in relation to the ISAs as evident in Appendix A10. Such comparison is important in facilitating and encouraging respondents' consideration of the similarities and differences between the two sets of standards. We encourage the Board to continue to apply this practice to its future proposals.

We would like to draw the Board's attention to certain matters noted from our review of Appendix A10. There are a few areas where the proposed requirements differ from the ISAs and, for information, we provide some additional information on the rationale behind the approach adopted in the ISAs. We do so with the hope that the Board will find these useful in providing relevant input to its continued development of the proposed standards, particularly in evaluating the basis for establishing differences between the proposed standards and the ISAs. Convergence in an area as fundamental to the audit as risk assessment is clearly in the best interests of promoting consistency in audit quality worldwide. Later, we also note a few general matters for clarification in connection with the ISAs.

Auditor's Responses to Assessed Risks versus Risks of Material Misstatement

Proposed Auditing Standard–*The Auditor's Responses to the Risks of Materials Misstatement* ("Response standard") requires the auditor to respond to *risks of material misstatement*. Page 4 of Appendix A10 indicates that a difference between the proposed Response standard and ISA 330 (Redrafted) *The Auditor's Responses to Assessed Risks* lies in the references in these standards to the auditor's responses to risks. The reference in the proposed Response standard to risks of material misstatement is in alignment with the Board's intention to distinguish separately, in the proposed standards, the auditor's identification of risks from the assessment of the degree of those risks. Under these standards, the auditor is then required to respond to the risks of material misstatements, taking into account, separately, the assessment of the degree of the risks in designing audit procedures.[1]

In contrast, ISA 330 (Redrafted) refers to the auditor's responses to *assessed risks.* By necessity, the use of assessed risks gives recognition to the integration of the different elements of the auditor's work in obtaining an understanding the entity and its environment.[2] In particular, it recognizes that the auditor identifies risks that are broader than strictly risks of material misstatement consequent of the auditor's work in obtaining an understanding of the entity's risk assessment process, including how the entity identifies and addresses business risks relevant to financial reporting objectives. It also recognizes that responses to risks of material misstatement inherently cannot be formulated in the absence of an understanding of the nature, magnitude and likelihood of such risks – that is, the auditor's assessment of the risks. This is particularly true in connection to formulating an overall response.

As an aside, we note that when considered together, paragraphs 56(a) and 56(d) in the proposed Assessment standard appear to be circular, as is the case with paragraphs 6 and 7 of the proposed Response standard.[3]

Auditor's Responses to Risks at the Financial Statement Level and Assertion Level

The proposed Response standard requires the auditor to implement overall responses to address the risks of material misstatement, and to design and perform audit procedures to address the risk of material misstatement for each relevant assertion of each significant account and disclosure. Page 5 of Appendix

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[1] Proposed Auditing Standard–The Auditor's Responses to Assessed Risks ("Assessment standard") requires the auditor to identify the risks of material misstatement (paragraph 56(a)) and, separately, assess the possibility that the risk could result in material misstatement (paragraph 56(d)). The auditor is then required by the proposed Response standard to design and implement overall responses to address the identified risks of material misstatement (paragraph 4), and, separately, to take into account the auditor's assessment of the risks (e.g., high, medium or low) in designing audit procedures (paragraph 7(a)).

[2] ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment" requires the auditor to identify risks (paragraph 25(a)) and consider the likelihood of misstatement (paragraph 25(d)). The auditor is then required by ISA 330 (Redrafted) to design and implement overall responses to address the assessed risks of material misstatement (paragraph 5) having regard for the risk assessment performed.

[3] Paragraphs 56(a) and 56(d) of the proposed Assessment standard require the auditor to identify the risks of material misstatement and also to assess the possibility that the risk [of material misstatement] could result in material misstatement of the financial statements. Paragraphs 6 and 7 of the proposed Response standard requires the auditor to design and perform audit procedures the nature, timing, and extent of which are based on and address the risks of material misstatement, but, separately, to do so taking account of the auditor's assessment of the risks.

A10 indicates that unlike ISA 330 (Redrafted), the proposed Response standard does not require the auditor to match overall responses to financial statement risks and responses involving audit procedures to assertion level risks.

ISA 330 (Redrafted) suggests a matching of the form of response to whether a risk constitutes a financial statement level risk or an assertion level risk in recognition of the fact that risks at the financial statement level are, by their nature, inherently different from those at the assertion level. Such risks relate pervasively to the financial statements as a whole and they are not necessarily identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Financial statement level risks therefore do not lend themselves to procedures as a response; rather, they represent circumstances that may increase the risk of misstatement at the assertion level and, hence, influence the auditor's general approach to the audit.

Other Matters

We note that a fair amount of explanatory and other application guidance materials currently present in the respective interim standards of the Board and comparable ISAs have not been included in the proposed standards. In the context of the ISAs, the IAASB believes that such guidance is important to the consistent and proper application of the standards and, as such, is treated as integral part of the standards themselves.

In relation to Appendix A10, the precision of the statements made is important to the proper understanding of the differences between the proposed standards and equivalent ISAs. We note a few instances where the conclusions with respect to ISAs are not fully consistent with the standards themselves. For example:

- Page 1 of Appendix A10 indicated that the provisions of the Proposed Auditing Standard–*Audit Risk in the Audit of Financial Statements* are similar to the discussion of audit risk in ISA 200 (Revised and Redrafted) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*. In contrast to the proposed standard, ISA 200 (Revised and Redrafted) contains more extensive guidance for example, with regard to the two components of audit risks–the risk of material misstatement and detection risk.
- Page 3 of Appendix A10 indicated that ISA 315 (Redrafted) does not specify a sufficiency requirement similar to that in the proposed Assessment standard with respect to the auditor's understanding of internal control over financial reporting. Whilst not positioned as requirements, paragraphs A3 and A38 of ISA 315 (Redrafted) did provide guidance in this regard.[4]

The Board appropriately used the final approved text of the 'Clarity version' of the relevant ISAs in performing its analyses. As the IAASB completed its final few clarified ISAs, it also undertook an overall review of all the approved standards for consistent use of language and necessary conforming changes. The final versions of the standards, including ISA 315 (Redrafted) and ISA 330 (Redrafted), with changes to the original text shown in mark-ups can be found on the IAASB website at http://www.ifac.org/IAASB/Meetings/Resources/0144/Updated+Agenda.

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[4] Paragraph A3 of ISA 315 (Redrafted) explains that the extent of the auditor's understanding of the entity and its environment required, including internal control, is determined by whether the auditor's understanding is sufficient to identify and assess the risks of material misstatement and thereby provide a basis for responding to the assessed risks. Paragraph A38 of ISA 315 (Redrafted) explains that an understanding of internal control will assist the auditor to identify types of potential misstatements and factors that affect the risks of material misstatement, and design the nature, timing, and extent of further audit procedures.

If you have any questions regarding the above, please do not hesitate to contact me at jimsylph@ifac.org or 212-286-9348, or alternatively, James Gunn, IAASB Deputy Director at jamesgunn@ifac.org or 212-286-9532. As the Board progresses its work in amending and replacing its interim standards, the staff of the IAASB would be pleased to discuss any matters in connection with the ISAs that may be of assistance to the staff of the Board, as appropriate.

Yours sincerely,

James M. Sylph

James M. Sylph
Executive Director, Professional Standards

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Reference: PCOAB's Rulemaking Docket 026: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk; Proposed Conforming Amendments to PCAOB Standards

November 10, 2008

ISG Metrics assists financial companies in achieving the highest ethical standards and related values with accountability and transparency through synchronized compliance on interconnected federal regulations and Operational Risk Ratings.

ISG Metrics applauds the PCAOB's efforts to strengthen the assessment of and response to risk by auditors through Rulemaking Docket 026.

This communication will help financial firms achieve the highest ethical standards and related values through synchronized compliance with laws and regulations. This involves:

1) Solving regulatory compliance risks that directly impact internal controls on financial reporting based on industry standards.

2) Incorporating new regulatory requirements from October 2008 into compliance risk assessment models.

3) Providing synchronized compliance - a holistic, coordinated solution to compliance risks with each member of the financial community applying existing standards and regulations with transparency and accountability so that financial firms can achieve the highest ethical standards and thus improve enterprise values.

Currently, there are three interconnected regulatory compliance risks that directly impact internal controls on financial reporting based on industry standards.

The newest compliance risk, per the Emergency Economic Stabilization Act (EESA) dated 10-3-08, is misrepresentation. Misrepresentations are reportable events to the Attorney General of the United States. Misrepresentations include fraud, misrepresentations and malfeasance in the development, advertising and sale of financial services, misrepresentations in the representations and warranties of the US Treasury's TARP Capital Purchase Program and misrepresentations in the advertising of the Federal Deposit Insurance Corporation brand.

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

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Misrepresentations per the EESA capture the two other compliance risks. These are compliance violations with safety and soundness regulations that risk termination of federal deposit insurance and illegal acts per Section 10a of the Securities Exchange Act of 1934. Illegal act means "an act or omission that violates any law, or any rule or regulations having the force of law."

Failure of Boards of Directors to have adequate oversight and awareness of these regulatory compliance risks, including illegal acts, represents negligence and breaches of fiduciary duties. Most importantly, the failure of Boards of Directors to remediate material illegal acts, such as misrepresentations per the EESA and/or violations of safety and soundness regulations require auditing firms to report these violations to the Securities Exchange Commission and either qualify their auditing opinion or resign from the audit engagement – actions that have a direct impact on financial reporting.

ISG Metric's Solution: Synchronizing compliance of complex interconnected federal regulations will enable financial firms to achieve the highest ethical standards, thus improving enterprise values. This requires each member of the financial community to apply existing standards and regulations with transparency and accountability.

The benefit of achieving the highest ethical standards is a higher enterprise value, thus ethics pays. Ethics pays is a quote from COSO's Enterprise Risk Management Framework.

Enclosed is our analysis of the multi-facted issues, which we are prepared to discuss with you at your convenience.

Sincerely,

Beckwith B. Miller
Chief Executive Officer

Addendum 1 – Public Comments – PCAOB's Rulemaking Docket 026

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

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Addendum 1 – Public Comments – PCAOB's Rulemaking Docket 026

Paragraph	Topic
1	Introduction
2	Executive Summary
3	Code of Ethics per Sarbanes-Oxley 406
4	COSO's Internal Control Framework, May 1994
5	COSO's Enterprise Risk Management Framework
6	Synchronized compliance will solve interconnected compliance risks as of October, 2008
6-a	Misrepresentations per Emergency Economic Stablization Act
6-b	Illegal Acts per Section 10a; 15 U.S.C. § 78j-1 Audit Requirements of the Securities Exchange Act of 1934
6-c	Compliance Risk per Federal Reserve's Supervisory Letter SR 08-8 including violation of safe and sound banking regulations.
6-d	Compliance risks, illegal acts, ethical values and ethical behavior per the PCAOB's Rulemaking Docket 026: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk; Proposed Conforming Amendments to PCAOB Standards
7	ISG Metric's assists financial companies in achieving the highest ethical standards with accountability and transparency through synchronized compliance on the interconnected federal regulations and Operational Risk Ratings.
8	Definitions

1) Introduction: Our comments and recommendations are focused on helping financial firms achieve the highest ethical standards and related values per 3 interconnected dimensions, i.e.,

   a) Solving regulatory compliance risks that directly impact internal controls on financial reporting based on industry standards. These include:

      i) COSO's Internal Control – Integrated Framework, May 1994.

      ii) COSO's Enterprise Risk Management. This states that ethics pays.

      iii) Sarbanes Oxley 404. This states "Internal control over financial reporting means providing reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements."

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

iv) Sarbanes-Oxley 406's Code of Ethics.

v) The Federal Reserve Board's Supervisory Letter 08-8 on compliance risk, including safe and sound banking regulations. Compliance is required for maintaining federal deposit insurance.

vi) Misrepresentations per the Emergency Economic Stabilization Act. Misrepresentations are to be reported to the Attorney General of the United States.

vii) Illegal acts per Section 10a of the Securities Exchange Act of 1934. Illegal act means "an act or omission that violates any law, or any rule or regulations having the force of law." Illegal acts, if material, must be remediated by the Board. If not, auditors must report these to the Securities Exchange Commission and either qualify their opinion or resign from the engagement.

b) Incorporating relevant events and new regulatory requirements from October 2008 into compliance risk assessment models. These include:

i) The PCAOB's Rulemaking Docket 026: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk; Proposed Conforming Amendments to PCAOB Standards dated 10-21-08.

ii) The principles of the Federal Reserve's Supervisory Letter 08-8, dated 10-16-08. This states, "organizations must comply with applicable rules and standards".

(1) These include safe and sound banking regulations required for maintaining federal deposit insurance.

iii) The Emergency Economic Stabilization Act (EESA). This was enacted on 10-3-08 with a clear focus on regulatory oversight, regulatory compliance and reporting misrepresentations to the Attorney General. Key factors include:

(1) Misrepresentations are reportable events to the Attorney General.

(a) The EESA's Financial Stability Oversight Board (FSOB) shall "report any suspected fraud, **misrepresentation**, or malfeasance to the Special Inspector General for the Troubled Assets Relief Program or the Attorney General of the United States, consistent with section 535(b) of title 28, United States Code." EESA - Section 104

(2) Misrepresentations, fraud and malfeasance on the development, advertising and sale of financial services expose the federal financial regulators to investigations by the FBI. EESA - Section 127

(3) Misrepresentations on the advertising of the Federal Deposit Insurance brand are violations of the EESA-Section 126.

(4) Misrepresentations or violations of the representations and warranties under the $250 billion US Treasury's TARP Capital Purchase Program are reportable events to the Attorney General.

(5) New monthly EESA hearings by the Congressional Oversight Panel begin on11-18-08.

(6) Congressman Barney Frank's 10-31-08 statement that "the federal government will insist on compliance" with the provisions of the US Treasury's TARP Capital Purchase Program.

(7) Members of the FSOB. These include the Chairman of the Board of Governors of the Federal Reserve System; Secretary of the Treasury, Director of the Federal Housing Finance Agency; Chairman of the Securities Exchange Commission; Secretary of Housing and Urban Development.

c) Providing synchronized compliance - a holistic, coordinated solution to compliance risks with each member of the financial community applying existing standards and regulations with transparency and accountability so that financial firms can achieve the highest ethical standards and related enterprise values.

2) Executive Summary: To achieve the highest ethical standards and related enterprise values, financial firms need to synchronize compliance with transparency and accountability on interconnected regulations to the standards set in the Code of Ethics per Sarbanes-Oxley 406 and COSO's Internal Control Framework and COSO's Enterprise Risk Management.

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

a) Financial firms include federally insured financial firms plus their auditors and federal financial regulators.

b) Interconnected regulations include safety and soundness, consumer protection, Sarbanes-Oxley and the Securities Exchange Act. These are cited in the Federal Reserve's Supervisory Letter 08-8.

(1) The standards include full regulatory compliance or no exposure to material **illegal acts** or **misrepresentations**.

3) The Code of Ethics per Sarbanes-Oxley 406 "are written standards that are:

a) reasonably designed to deter wrongdoing and to promote:

i) **Compliance with applicable governmental laws, rules and regulations;**

ii) The prompt internal reporting to an appropriate person or persons identified in the code of violations of the code;

iii) **Accountability** for adherence to the code;

iv) Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

v) Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant."

b) reinforced by the Federal Sentencing Guidelines for Effective Compliance and Ethics Program.

4) COSO's Internal Control Framework dated May, 1994 is the foundation for internal controls on financial reporting in the United States.

a) "Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

i) Effectiveness and efficiency of operations.

ii) **Compliance with laws and regulations**.

iii) Reliability of financial reporting.

iv) Safeguarding of assets is an additional function that is intertwined with each of the first three functions.

(1) This is especially relevant for safety and soundness regulations whereby financial firms are obligated to safeguard their information assets from criminal acts.

b) The foregoing standards are embedded within the following regulations, which all state the same core principle:

i) NCUA Rule: § 715.2(h): "Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition refers to prevention or timely detection of transactions involving such unauthorized access, use, or disposition of assets which could result in a loss that is material to the financial statements."

ii) FDIC Proposed Rule, 11/1/07, 12 CFR Parts 308 and 363 Annual Independent Audits and Reporting Requirements; Proposed Rule: "The Institution's internal control over financial reporting includes those policies and procedures that (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Institution's assets that could have a material effect on the financial statements."

iii) Sarbanes-Oxley 404 (2003): "Internal control over financial reporting means providing reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements."

iv) SEC Rule 13a-15: Controls and procedures. " The term internal control over financial reporting is defined as a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial

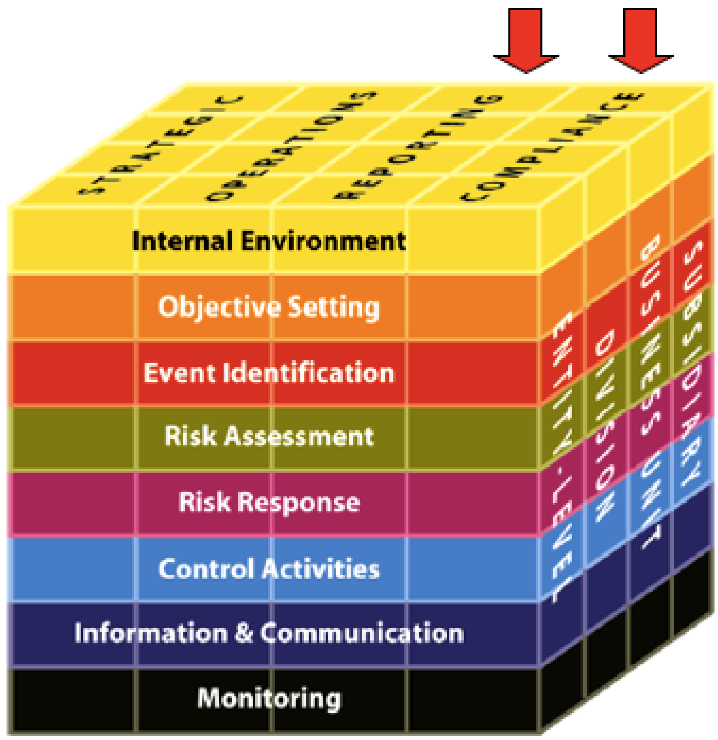
ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that: (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.“

5) COSO’s Enterprise Risk Management Framework:

a) focuses on compliance with laws and regulations with these core features:

i) Identify
ii) Assess
iii) Control
iv) Measure
v) Risk Tolerances
   (1) Compliance Ratings
vi) Monitor
vii) Report
viii) Train



b) states, “ethics pays”.

i) The section on **Integrity and Ethical Values states: “**An entity’s strategy and objectives and the way they are implemented are based on preferences, value judgments, and management styles. Management’s integrity and commitment to ethical values influence these preferences and judgments, which are translated into standards of behavior. Because an entity’s good reputation is so valuable, the

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

standards of behavior must go beyond mere **compliance with law**. Managers of well-run enterprises increasingly have accepted the view that

(1) ethics pays and

(2) ethical behavior is good business."

6) Synchronized compliance will solve interconnected compliance risks as of October 2008, i.e.,

- **misrepresentations** per the Emergency Economic Stabilization Act of 10-3-08.
- **compliance risks** per the Federal Reserve's Supervisory Letter 08-8 of 10-16-08.
- **illegal acts, regulatory compliance risks**, and **ethical issues** per the PCAOB's Rulemaking Docket 026 of 10-21-08: "Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk; Proposed Conforming Amendments to PCAOB Standards."
- Each issue is defined below:

a) **Misrepresentation** is a key term per the Emergency Economic Stabilization Act (EESA), i.e.,

i) **Misrepresentation** or any suspected fraud or malfeasance under the EESA is to be reported to the Attorney General per Section 104.

ii) **Misrepresentations** or violations of the representations and warranties of the $250 billion TARP Capital Purchase Program are reportable events to the Attorney General per Section 104.

iii) **Misrepresentations** on the development and sale of financial products expose federal financial regulators to investigations by the FBI per Section 127.

iv) **Misrepresentations** on the advertising of the Federal Deposit Insurance Corporation brand is a violation per Section 126.

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

b) **"Illegal Acts"** per Section 10a; 15 U.S.C. § 78j-1 Audit Requirements of the Securities Exchange Act of 1934 is a fundamental legal term. It sets clear performance standards for auditors and Boards of Directors. It is cited by the PCAOB in its Rulemaking Docket 026: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk; Proposed Conforming Amendments to PCAOB Standards, dated 10-21-08.

i) Illegal Acts means "an act or omission that violates any law, or any rule or regulations having the force of law."

(1) Auditors and Boards of Directors are obligated to investigate illegal acts. If material, Boards must remediate the illegal acts. Failure to remediate then requires the auditor to report the material illegal acts to the SEC and either:

(a) depart from a standard report of the auditor, when made, or

(b) warrant resignation from the audit engagement.

(2) Searching the PCAOB's web site for enforcement cases on "illegal acts" reports 2 enforcement cases.

c) "**Compliance risk**" is a core definition and theme in the Federal Reserve's Supervisory Letter SR 08-8, dated 10-16-08, Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles.

i) "**Compliance risk** is the risk of legal or regulatory sanctions, financial loss, or damage to reputation resulting from failure to comply with laws, regulations, rules, other regulatory requirements, or codes of conduct and other standards of self-regulatory organizations applicable to the banking organization (applicable rules and standards)."

ii) "**Compliance risk** does not lend itself to [risk appetites and] similar processes for establishing and allocating overall risk tolerance, in part because **organizations must comply with applicable rules and standards."**

iii) Effective **compliance risk** management programs incorporate controls designed to maintain compliance with

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

(1) applicable rules and standards, including

(2) consumer protection guidance issued by supervisory authorities and

(3) safety and soundness regulations.

(a) Note from ISG Metrics: For further clarification, safety and soundness regulations are defined for all federally insured firms in the following letter dated 9-16-08 from the General Accountability Office to Congressional Committees for the Department of Homeland Security: GAO-08-1075R – Federal Legal Requirements for Critical Infrastructure IT Security.

(i) An enforcement option for failing to comply with safe and sound regulations is the termination of federal deposit insurance.

iv) "The Federal Reserve's expectations for all supervised banking organizations are consistent with the principles outlined in a paper issued in April 2005 by the Basel Committee on Banking Supervision, entitled *Compliance and the compliance function in banks* (Basel compliance paper). The principles in the Basel compliance paper have become widely recognized as **global sound practices for compliance risk management** and oversight, and the Federal Reserve endorses these principles."

v) "The Federal Reserve strongly encourages large banking organizations with complex compliance profiles to ensure that the necessary resources are dedicated to fully implementing effective firmwide **compliance risk** management programs and oversight in a timely manner."

vi) "The board should exercise reasonable due diligence to ensure that the compliance program remains effective by at least annually reviewing a report on the effectiveness of the program. The board may delegate these tasks to an appropriate board-level committee."

d) **Compliance risks, illegal acts, ethical values and ethical behavior** are central issues per the following sections of the PCAOB's Rulemaking Docket 026: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk; Proposed Conforming

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

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Amendments to PCAOB Standards. The columns below represent the Paragraph # (A), Page # (B), and relevant issue (C) from the PCAOB's Rulemaking Docket 026.

A	B	C
7	APPENDIX 2 – PROPOSED AUDITING STANDARD – AUDIT PLANNING AND SUPERVISION **Planning Activities** Page A2–3 – Standard Page A2–4 – Standard	The nature and extent of planning activities that are necessary depend on the size and complexity of the company, ○ Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, **laws and regulations,** and technological changes; ○ **Legal or regulatory** matters of which the company is aware;
9	APPENDIX 3 – PROPOSED AUDITING STANDARD *Obtaining an Understanding of the Company and Its Environment* Page A3–4– Standard	The auditor's understanding of the company should include the following: a. Relevant industry, **regulatory**, and other external factors;
11	Industry, **Regulatory**, and Other External Factors Page A3–4– Standard	Industry, regulatory, and other external factors that are relevant to the auditor's understanding of the company include industry factors such as the competitive environment and technological developments; the **regulatory** environment, including the applicable financial reporting framework6/ and the legal and political environment;7/ and other external factors such as general economic conditions. See AU sec. 317, ***Illegal Acts*** *by Clients*, for additional direction regarding the auditor's consideration of laws and regulations relevant to the audit.

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

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15	**Company Objectives, Strategies, and Related Business Risks** Page A3–6– Standard Page A3–7– Standard	The following are examples of business risks that might be relevant to the auditor's consideration of the company's, strategies and related business risks – **Regulatory** requirements (a potential related business risk might be, for example, that there is increased legal exposure). Note: Some relevant business risks might be identified through other risk assessment procedures, such as obtaining an understanding of the nature of the company and understanding industry, **regulatory**, and other external factors.
19	**Selection and Application of Accounting Principles** Page A3–8– Standard	The auditor should obtain an understanding of the following matters, if applicable, in obtaining an understanding of the company's selection and application of accounting principles: ○ Financial reporting standards and **laws and regulations** that are new to the company and when and how the company will adopt such requirements
26	**Control Environment** Page A3–11– Standard	Auditor should address: whether sound integrity and **ethical values**, particularly of top management, are developed and understood;
30	**Information System Relevant to Financial Reporting and Communication** Page A3–12– Standard Page A3–13– Standard	*Business Processes.* A company's business processes are the activities designed to: (b) Ensure **compliance with laws and regulations** relevant to the financial statements;
33	*Communication.*	*Communication.* The auditor should obtain an understanding of how the company

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

	Page A3–14– Standard	communicates financial reporting roles and responsibilities and significant matters relating to financial reporting including – ○ Communications to external parties, including **regulatory** authorities and shareholders.
52	**Inquiries Regarding Fraud Risks** Page A3–19– Standard	Auditor should include the following: ○ whether and how management communicates to employees its views on **business practices and ethical behavior**;
65	**Further Consideration of Controls** Page A3–24– Standard	Controls that address fraud risks include (a) specific controls designed to mitigate specific risks of fraud, e.g., controls to address risks of misappropriation of specific assets and (b) controls designed to prevent, deter, and detect fraud, e.g., controls to promote a culture of honesty and **ethical behavior.25/** Such controls also include those that address the risk of management override of other controls.
24	**APPENDIX 5 – PROPOSED AUDITING STANDARD** **Accumulating and Evaluating Identified Misstatements** Page A5–7– Standard	If the auditor becomes aware of information indicating that fraud or another **illegal act** has occurred or might have occurred, he or she also must determine his or her responsibilities under AU sec. 316, AU sec. 317, ***Illegal Acts by Clients,*** **and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1.**
	APPENDIX 8 – PROPOSED CONFORMING AMENDMENTS TO PCAOB STANDARDS Page A8–11– Conforming Amendments	AU sec. 317, "Illegal Acts by Clients" SAS No. 54, "Illegal Acts by Client" (AU section 317, "Illegal Acts by Clients"), is amended as follows – a. The last sentence of paragraph .13 is replaced with – **An illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a**

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

		material loss of revenue.
	AU Section 317 ***Illegal Acts by Clients*** **(Source: SAS No. 54.** **See** section 9317 **for interpretations of this section.** **Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated)**	**The Auditor's Consideration of Financial Statement Effect** **.13** In evaluating the materiality of an illegal act that comes to his attention, the auditor should consider both the quantitative and qualitative materiality of the act. For example, section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .11, states that **"an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue."**
	APPENDIX 9 *Additional Discussion of Proposed Auditing Standards and Conforming Amendments* Page A9–9–Additional Discussion	The interim standard requires the auditor to consider the collective effect on the control environment of strengths and weaknesses in the various control environment factors.9/ The proposed standard replaces that requirement with a new requirement to assess the following matters as part of obtaining an understanding of the control environment: • Whether management's philosophy and operating style promote effective internal control over financial reporting; • Whether sound integrity and **ethical values,** particularly of top management, are developed and understood; and • Whether the board or audit committee understands and exercises
	Proposed Auditing Standard – Consideration of Materiality in Planning and Performing an Audit Page A9–28–	AU sec. 312.19 discusses establishing an overall materiality level based on the smallest aggregate level of misstatement that would be considered material to any of the individual financial statements. The proposed standard establishes a responsibility for the auditor to consider whether, for particular accounts or disclosures, misstatements in

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

	Additional Discussion Page A9–29– Additional Discussion	amounts less than the materiality level for the financial statements as a whole could influence the judgment of a reasonable investor. In those circumstances, the auditor is required to establish separate materiality levels for such accounts or disclosures. The formulation in the proposed standard is more consistent with the principle of considering the perceptions of investors when making materiality judgments because it recognizes that, in certain circumstances, misstatements in some accounts might have more significant consequences than in other accounts. The following are examples of situations in which a lower materiality threshold might be needed: • **Laws, regulations**, or the applicable financial reporting framework affect investors' expectations about the measurement or disclosure of certain items, e.g., related party transactions and compensation of senior management. • Significant attention has been focused on a particular aspect of a company's business that is separately disclosed in the financial statements, e.g., a recent business acquisition. • Certain disclosures are particularly important to investors in the industry in which the company operates.
	APPENDIX 10 *Comparison of Requirements to the Standards of the International Auditing and Assurance Standards Board*1/	In obtaining an understanding of the control environment, ISA 315 requires the auditor to evaluate whether (a) management, with the oversight of those charged with governance, has created and maintained a culture of honesty and **ethical behavior;** and (b) the strengths in the control environment elements collectively provide an appropriate

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

	Page A10–3–Comparison Page A10–3–Comparison	foundation for the other components of internal control, and whether those other components are not undermined by control environment weaknesses. The proposed standard requires an additional assessment related to the control environment, but the requirement is aligned more closely with Auditing Standard No. 5.

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

7) ISG Metric's assists financial companies in achieving the highest ethical standards with accountability and transparency through synchronized compliance on the interconnected federal regulations and Operational Risk Ratings. The process includes:
   a) calibrating an organization's compliance with:
      i) the interconnected regulations that include misrepresentations per EESA, safety and soundness regulations, consumer protection regulations and regulations by the Securities and Exchange Commission,
      ii) publicly available information, and
      iii) full compliance per the publicly defined compliance scale of CAMELS or CAMEL. A CAMELS 1 rating equals full compliance and a 5 rating equals critically deficient compliance.
         (1) CAMELS Ratings are cited in the Federal Reserve's Supervisory letter 08-8.

COSO's Enterprise Risk Management	
Risk Tolerances	
1 1 1	Substantial Compliance
2 2 2	Satisfactory Compliance
3 3 3 3	Significant Non-Compliance
4 4 4 4	Significant Deficiencies
5 5 5	Critically Deficient
CAMELS Rating Scale	Operational Risk Ratings

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

(2) Risks are converted into comparable Operational Risk Ratings and posted online for transparency.

(a) www.operationalriskratings.com

b) a full risk assessment through Operational Risk Profile Reports. These analyze the risks described herein per the Basel II operational risk framework on fiduciary breaches, external fraud and process management. Current reports are available online for a wide cross section of federal financial firms.

(a) www.operationalriskratings.com

c) The Director Scorecard™. This is a periodic report that calibrates degrees of compliance per Basel II on operational risks that include fiduciary breaches, external fraud and process management risks with the relevant Operational Risk Ratings and CAMELS compliance ratings.

d) full remediation services including legal.

e) helping Boards of Directors achieve the standards cited in the Federal Reserve's Supervisory letter 08-08.

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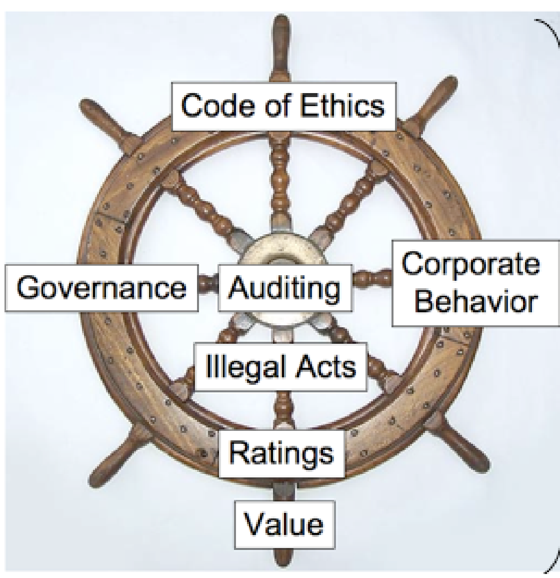

COSO's Enterprise Risk Management Risk Tolerances	
1 1 1	Substantial Compliance
2 2 2	Satisfactory Compliance
3 3 3 3	Significant Non-Compliance
4 4 4 4	Significant Deficiencies
5 5 5	Critically Deficient
CAMELS Rating Scale	Operational Risk Ratings

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

Boards, according to the Federal Reserves Supervisory letter 08-08, "should be knowledgeable about the general content of the compliance program and exercise appropriate oversight of the program. Accordingly, the board should review and approve key elements of the organization's compliance risk management program and oversight framework, including firmwide compliance policies, compliance risk management standards, and roles and responsibilities of committees and functions with compliance oversight responsibilities. The board should oversee management's implementation of the compliance program and the appropriate and timely resolution of compliance issues by senior management. The board should exercise reasonable due diligence to ensure that the compliance program remains effective by at least annually reviewing a report on the effectiveness of the program. The board may delegate these tasks to an appropriate board-level committee."

8) **Definitions:**

a) "**Compliance risk**" is a core definition and theme in the Federal Reserve's Supervisory Letter SR 08-8, dated 10-16-08, Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles.

i) "**Compliance risk** is the risk of legal or regulatory sanctions, financial loss, or damage to reputation resulting from failure to comply with laws, regulations, rules, other regulatory requirements, or codes of conduct and other standards of self-regulatory organizations applicable to the banking organization (applicable rules and standards)."

b) **"Illegal Acts"** per Section 10a; 15 U.S.C. § 78j-1 Audit Requirements of the Securities Exchange Act of 1934 is a fundamental legal term. It sets clear performance standards for auditors and Boards of Directors. It is cited by the PCAOB in its Rulemaking Docket 026: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk; Proposed Conforming Amendments to PCAOB Standards, dated 10-21-08.

i) Illegal Acts means "an act or omission that violates any law, or any rule or regulations having the force of law."

(1) Auditors and Boards of Directors are obligated to investigate illegal acts. If material, Boards must remediate the illegal acts. Failure to

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

remediate then requires the auditor to report the material illegal acts to the SEC and either:

(a) depart from a standard report of the auditor, when made, or

(b) warrant resignation from the audit engagement.

c) **Misrepresentation** is a key term per the Emergency Economic Stabilization Act (EESA), i.e.,

  i) **Misrepresentation** or any suspected fraud or malfeasance under the EESA is to be reported to the Attorney General per Section 104.

  ii) **Misrepresentations** or violations of the representations and warranties of the $250 billion TARP Capital Purchase Program are reportable events to the Attorney General per Section 104.

  iii) **Misrepresentations** on the development and sale of financial products expose federal financial regulators to investigations by the FBI per Section 127.

  iv) **Misrepresentations** on the advertising of the Federal Deposit Insurance Corporation brand is a violation per Section 126.

d) **Safety and Soundness Regulations** are defined for all federally insured firms in the following letter dated 9-16-08 from the General Accountability Office to Congressional Committees for the Department of Homeland Security: GAO-08-1075R – Federal Legal Requirements for Critical Infrastructure IT Security.

  i) An enforcement option for failing to comply with safe and sound regulations is the termination of federal deposit insurance.

Final page of public comments dated November 10, 2008.

ISG Metrics LLC
5100 Tamiami Trail North, Suite 105
Naples, Florida 34103 T-239-777-4638
info@isgmetrics.com - www.isgmetrics.com

THE UNIVERSITY OF TEXAS AT AUSTIN
McCOMBS SCHOOL OF BUSINESS

February 18, 2009

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Ref. PCAOB Rulemaking Docket Matter No. 026

I appreciate the opportunity to comment on "The Auditor's Assessment of and Response to Risk." The comments are based on my experiences as an auditing professor; as a member of auditing standards setting bodies, including volunteer service as a member of the IAASB; and as an occasional expert witness in private and SEC audit-related litigation. However, the comments reflect my personal views.

Overall, I congratulate the Board for considering updates to *Interim Standards* in order to be more in line with those of other standards setting bodies. Elimination of unnecessary differences (page 8) is worthy of the Board's effort. Multiple sets of standards impose cost burdens on accounting students (and their professors), practicing auditors, audit firms, and the PCAOB, as well as society that ultimately must pay the costs of multiple standards and any differences should be justified.

My comments focus on a few specific paragraphs regarding the concepts of the integrated audit and materiality that I believe are confusing and may reduce audit quality rather than providing clear guidance that will help auditors, protect investors, and further the public interest.

Page A3-3, para. 7: This paragraph states "In an integrated audit, the auditor's risk assessment procedures are the same for both the audit of internal control over financial reporting and the audit of financial statements." I believe that this statement is misleading because it implies that there is *no difference* in procedures for the two audits. As Abe Akresh (GAO) makes clear in a recent academic paper ("Using the audit risk model to opine on internal control," December 9, 2008) the internal control audit focuses on the *risk of failing to detect material weaknesses,* rather than the risk of failing to detect material misstatements.

For example, internal control audits require consideration of whether the auditor's *own procedures* for evaluating the design of internal controls might fail to detect a material design weakness, while tests of controls in financial audits facilitate assessment of control risk *per se* (see also, comment on page A4-6, para. 14 and 17). The two objectives are related but distinct, and because internal control audits are uniquely American, it is important for American standards to "get concepts right."

William R. Kinney, Jr. · Prothro Chair in Business · 1 University Station B6400 · Austin, TX 78712-0211 · 512.471.3632 phone · 512.471.3904 fax

Page A3-21, para. 56 : This paragraph should cross reference "tolerable misstatement" at the assertion level (see page A6-4, para. 8) to make clear that the risk assessment at the assertion level is based on an amount less than materiality for the financial statements as a whole. Otherwise, too little substantive auditing of each component might result.

Page A4-6, para. 14 and 17: These two paragraphs refer to a subtle difference between the objectives of internal control audits and financial statement audits with respect to Tests of Controls. One refers to a conclusion about whether controls are effective and the other to the auditor's control risk assessments (see comment on page A3-3, para. 7). It would be helpful to highlight and explain implications of the difference in objectives – perhaps as a Note.

Page A6-3, para. 3: The revision deletes explicit reference to the important and long standing concept of "quantitative" materiality, refers to the concept as "material based solely on qualitative factors," and demotes to a Note the warning about the auditor's inability to design practical (which I presume means cost effective) auditing procedures to detect quantitatively immaterial but qualitatively material misstatement. I assure you that the omission and demotion will cause much needless confusion to future auditing students because reference to this important limitation of auditing is indirect and thus obscure. Also, it will cause unnecessary discussion in preparation for audit litigation.

Page A6-4, para. 8: The first sentence is incomplete or misleading because it omits reference to the need to apply "tolerable misstatement" at the assertion, account balance, or class of transaction level when planning and performing audit procedures. One could read this paragraph as being applicable at the financial statement level rather than at a component level. A literal reading of present paragraph 8 would greatly *reduce* the amount of auditing traditionally applied, which is likely not the Board's intent.

I hope that the Board and its staff will find the above comments useful, and I would be pleased to discuss, elaborate, or answer questions about any points raised.

Sincerely,

William Kinney

William Kinney
Professor

KPMG LLP
757 Third Avenue
New York, NY 10017

Telephone 212-909-5600
Fax 212-909-5699
Internet www.us.kpmg.com

February 18, 2009

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C., 20006-2803

PCAOB Rulemaking Docket Matter No. 026
Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Conforming Amendments to PCAOB Standards

Dear Mr. Secretary:

KPMG appreciates this opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) Release No. 2008-006, "*Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Conforming Amendments to PCAOB Standards,*" that includes the following proposed auditing standards as appendices (collectively, the Proposals):

- *Audit Risk in an Audit of Financial Statements*
- *Audit Planning and Supervision*
- *Identifying and Assessing Risks of Material Misstatement*
- *The Auditor's Responses to the Risks of Material Misstatement*
- *Evaluating Audit Results*
- *Consideration of Materiality in Planning and Performing an Audit*
- *Audit Evidence.*

We would like to take this opportunity to formally recognize the significant effort of the PCAOB and its staff in development of the Proposals.

Effective identification and assessment of, and response to, risks are fundamental to the conduct of high quality audits. Further, global consistency in auditing standards and auditor execution relative to risk assessments and responses are important to furthering the objective of enhancing audit quality around the world. We support the Board's efforts to update its risk standards and believe that the final standards will improve auditor performance and enhance consistent execution in areas that are fundamental to the conduct of an audit.

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This letter is organized by first providing a number of general observations and comments on the Proposals as a whole, followed by comments on specific issues in the Attachment. Our general observations discussed below are organized by the following topics:

- Convergence of Auditing Standards
- Consistency of Risk Assessment Activities
- Prescriptive Nature of the Proposals
- Codification of the Board's Standards
- Integration of Fraud Guidance
- Scalability
- Organization and Content
- Effective Date

Convergence of Auditing Standards

We fully support the Board's consideration of the work of other standards setters, as evidenced by the degree of alignment of the Proposal's content with the corresponding risk assessment standards issued by the International Auditing and Assurance Standards Board (IAASB) and the Auditing Standards Board of the AICPA (ASB). We acknowledge steps taken to date and urge the PCAOB to continue its consideration of auditing standards convergence, with the overarching objective of enhancing audit quality around the world.

Converged auditing standards will serve to enhance auditors' understanding, implementation, and consistent application of standards on *all* audits they perform, beyond those subject to the Board's oversight. Enhanced understanding, implementation and consistent application of auditing standards will serve to improve the quality of audits on a broad basis. Additionally, appropriate convergence affords auditing firms the ability to avoid redundant costs, for example, by allowing for synergies related to training, implementation, and the development and maintenance of quality control systems that accommodate the standards of the various standards-setting bodies.

We acknowledge the analysis of significant differences in requirements between the Proposals and those of the corresponding International Standards on Auditing (ISA) included in Appendix 10 of the Proposals. In light of the increasing global acceptance of the ISAs, we believe that the Board should provide a more detailed comparison of these and future proposed standards with those of the IAASB. A robust comparison will help auditors better understand differences in the standards and promote further convergence of auditing standards and auditor performance

We support the following remarks made by Board member Bill Gradison at the Board's October 21, 2008, open meeting:

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> "For the first time, the PCAOB is putting out a new standard for comment that includes an extensive comparison of its proposal with the standards promulgated by another standard setter, in this case the Risk Assessment Auditing Standards of the International Auditing and Assurance Standards Board - the so-called ISAs. I would hope that the PCAOB would continue to put out such comparative information in connection with future proposals for new PCAOB standards. We are fast entering an auditing environment with three differing standards, especially as the PCAOB gradually replaces its interim standards (the pre-2003 ASB standards) and the ASB revises its standards, using the ISAs as the base - that is, "ISAs plus." I don't know whether over the long run having three standards is sustainable, but as long as there are three standards, I believe each standard setter has a responsibility to make it as clear as possible how its standards differ from those of the other two standard setters so that practitioners know what is expected of them. Today's Board action is, in my mind, a constructive step in that direction."

Consistency of Risk Assessment Activities

We support the Board's stated goal of enhancing integration of the audit of the financial statements with the audit of internal control over financial reporting. We agree with the statement in paragraph 7 of Appendix 3 of the Proposals that, "In an integrated audit, the risks of material misstatement of the financial statements are the same for both the audit of internal control over financial reporting and the audit of the financial statements. Accordingly, the auditor's risk assessment procedures should apply to both the audit of internal control over financial reporting and the audit of the financial statements."

We believe that the auditor's process for identifying and assessing risks should be the same in both an integrated audit and an audit of financial statements only, and that differences in the conduct of integrated and financial statement only audits should arise only in the auditor's response to assessed risks.

However, there are a number of areas in which we believe that the Proposals do not align with the Board's stated goal. First, the use of a "top-down" approach is neither encouraged nor required in the Proposals, whereas paragraph 21 of Auditing Standard No. 5 (AS 5) states that, "The auditor should use a top-down approach…" We believe that the use of a top-down approach is particularly relevant in identifying and assessing risks of material misstatement. We recommend that the Board consider adding language to the Proposals similar to that found in paragraph 21 of AS 5.

Second, the Proposals do not appear to contemplate the risk assessment activities noted in paragraphs 34 through 38 of AS 5. We note that such paragraphs provide for certain basic risk assessment activities to be undertaken to identify risks at the assertion level.

We recommend that the Board clarify that the process for identifying and assessing risks of material misstatement is the same in an audit of internal control over financial reporting and in an audit of financial statements only. Doing so would serve to reduce the risk that an auditor might execute a non-integrated approach for assessing risks and obtaining audit evidence when performing an integrated audit.

Finally, we believe that the guidance in paragraphs 46 and 47 of AS 5 regarding risk of control failure also is relevant to the risk identification and assessment process when the auditor intends to place reliance

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on a control for audits of financial statements only. Accordingly, we recommend that the final standards include this guidance as applicable to both integrated audits and audits of financial statements only.

Prescriptive Nature of the Proposals

We believe that the Proposals are unnecessarily prescriptive and may limit the auditor's ability to exercise professional judgment to design and implement audit procedures that appropriately address the risks of material misstatement in the most efficient manner. Furthermore, audit documentation of compliance with these prescriptive measures may have a negative effect on audit efficiency. Our detailed comments in the Attachment provide specific examples of areas where we believe that the Proposals are written in an overly-prescriptive manner and may have the unintended consequence of reducing audit efficiency without a concomitant increase in audit effectiveness. We recommend that the Board reconsider the need for each of the mandatory or presumptively mandatory auditor performance matters included in the Proposals.

Codification of the Board's Standards

We support the Board's objective of looking to the Proposals as a foundation for its future standard-setting activities. However, we believe that the current organization of the PCAOB's auditing standards, as a whole, impedes the most effective and efficient application of those standards. More specifically, we note that the introduction of these standards into the Board's framework will add a significant layer of professional standards to existing interim standards and previously issued PCAOB auditing standards. As a result, we believe that the Board's standards are becoming increasingly cumbersome for an auditor to understand and effectively apply in practice. For example, if an auditor sought guidance with respect to assessing fraud risk in an integrated audit, he or she potentially would consult interim standard AU 316, AS 5, and the Proposals in order to gather all relevant guidance.

We recommend that the Board undertake a project, concurrent with the issuance of any final standard, to enhance the organization, consistency, and understandability of all of its standards. We believe that effective execution of the audit risk foundation standards requires a clear and understandable format that will be consistently applied in future standard-setting activities.

Integration of Fraud Guidance

We support the Board's stated intention of emphasizing the auditor's responsibilities for considering the risk of fraud during an audit. We also acknowledge the Board's view that deficiencies have been noted in some inspections of firms resulting from a 'mechanical' or 'checklist' approach to addressing fraud risk. However, while we support the Board's objective of ensuring that auditors consider fraud throughout an audit, we believe that the approach used in the Proposals of incorporating some components of AU 316, while leaving, amending, or deleting others in the existing interim standards, is confusing and may lead to misapplication of the relevant requirements. Specifically, an auditor may consult fraud guidance within an individual standard that is out of context or incomplete because of other guidance that may be contained in another standard. We believe that the Board's interim standards, located at AU 316, provide sound guidance relative the auditors' consideration of fraud in an audit. Accordingly, we recommend that the Board maintain interim standard AU 316 in its current form and provide application guidance, such as through the use of "Notes" in relevant sections of the final standards, to improve auditor performance in this area.

Scalability

The Proposals do not appear to consistently acknowledge that there may be significant differences with respect to identifying and assessing risks of material misstatement based upon size or complexity of entities. While the Proposals acknowledge that there may be differences between smaller and larger entities with respect to particular risk assessment activities, we believe that differences also exist in many of the areas encompassed by the Proposals. Accordingly, we recommend that the Proposals be revised by adding application guidance intended to assist auditors in determining appropriate procedures that may be effective in identifying and assessing risks of material misstatement at smaller, less complex entities.

Organization and Content

Use of Objectives in the Proposals

We agree with the Board's use of "objective of the auditor" in the Proposals. While our detailed comments below contain some suggested revisions to the objectives used in the Proposals, we believe that the use of objectives assists an auditor to understand the overall goal of his or her procedures. We recommend that the Board review the objectives included in the Proposals to ensure that they are drafted in a format that is outcome-based. For example, in paragraph 3 of Appendix 3 the Board might adopt an objective similar to the following from ISA 315 (redrafted) in order to provide linkage between identifying and assessing risks and designing and implementing responses to those risks.

"The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion level, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement."

Revision of "should consider" to "should evaluate" and "should assess"

We observe instances in the Proposals in which the Board has revised "should consider" guidance drawn from its interim standards or from the ISAs to "should evaluate," or to "should assess" guidance. These revisions will result in incremental auditor effort, including documentation. We encourage the Board to reconsider those areas where incremental auditor effort, including documentation, is reflected in the Proposals and determine whether the increase in auditor effort is appropriate in the circumstances.

Definitions

We believe that the Board should develop and follow a consistent approach with respect to definitions. Some of the Proposals include definitions in a separate 'Definitions' section, similar to the redrafted ISAs. Other Proposals define terms within the text of the respective standard. We also note that AS 5 provides a glossary of defined terms, inconsistent with both approaches noted in the Proposals.

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Effective Date

We encourage the Board to provide sufficient time between the final standards' issuance and effective dates for audit firms to incorporate the provisions of the final standards into their respective training programs, audit methodologies and related audit tools prior to implementation. Further, we strongly support the remarks of Board member Dan Goelzer at the Board's October 21, 2008 open meeting, where he noted that the Board might consider additional steps to promote transparency to its standard-setting process. Mr. Goelzer suggested potential actions such as circulating revised Proposals, initiating a second comment period and holding additional public forums or Board discussions to consider the comments. Finally, we encourage the Board to issue the final standards as a suite with the same effective dates.

****** ********

Set forth in the Attachment to this letter are comments on specific matters included in the Appendices and the conforming amendments to PCAOB Standards.

We fully support the Board's efforts to update and improve its existing audit risk standards. If you have any questions about our comments or other information included in this letter, please do not hesitate to contact Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com, Glen L. Davison, (212) 909-5839, gdavison@kpmg.com, or Craig W. Crawford, (212) 909-5536, ccrawford@kpmg.com.

Very truly yours,

KPMG LLP

cc: PCAOB Members and SEC Commissioners

PCAOB
Mark W. Olson, Chairman
Daniel L. Goelzer, Member
Willis D. Gradison, Member
Steven B. Harris, Member
Charles D. Niemeier, Member
Thomas Ray, Chief Auditor and Director of Professional Standards

SEC
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Luis A. Aguilar, Commissioner
Kathleen L. Casey, Commissioner
Troy A. Paredes, Commissioner
Elisse B. Walter, Commissioner
James Kroeker, Acting Chief Accountant

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ATTACHMENT
Page 1

Comments on Proposed Standards

	Appendix 1: Audit Risk in an Audit of Financial Statements
1a	Paragraph 6 – The proposed standard does not sufficiently describe the types of risks of material misstatement at the financial statement level and how to identify such risks. In order to provide sufficient guidance to auditors regarding the risk assessment process, we believe the PCAOB should include in this standard additional guidance similar to that included in ISA 315 paragraphs A98-A101 related to identification and assessment of risks of material misstatement at the financial statement level.
1b	Paragraph 10 – We believe that the language in the first sentence of paragraph 10 inappropriately limits the auditor's ability to reduce detection risk through the use of substantive procedures only. Detection risk might also be reduced through risk assessment procedures or tests of controls, as described in paragraph 13 of Appendix 7. We recommend that the first sentence in paragraph 10 be deleted.

	Appendix 2: Audit Planning and Supervision
2a	Paragraph 3 – We believe that the statement contained in paragraph 3 of the proposed standard is redundant and would be more appropriately included as a requirement of the auditor in sections of the proposed standard discussing "planning an audit" and "supervision".
2b	Paragraph 3 – We observe inconsistency in the use of the terms "must" and "should" within the Board's existing standards and the Proposals. For example, AS 5 paragraph 9 states that "the auditor should properly plan the audit of internal control over financial reporting and properly supervise any assistants," but paragraph 3 of the proposed standard states that "the auditor must adequately plan the audit and properly supervise the members of the engagement team." Because "must" and "should" impose different levels of responsibility on the auditor, we recommend that the Board conform use of the terminology and use "should" in this instance.

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2c	Paragraph 5 – The proposed standard states that "The engagement partner is responsible for planning the engagement but may seek assistance from other members of the engagement team". Appendix 9 of the release states that "The proposed standard also indicates that the engagement partner may seek assistance from other engagement team members because in many situations, particularly those involving larger or multi-location engagements, it is appropriate and necessary to do so." We believe that the statement in Appendix 9 is too limiting because the engagement partner seeks assistance from other engagement team members in virtually all audit engagements, not just those involving larger or multi-location engagements.
2d	Paragraphs 13 – 15 – The proposed standard addresses the auditor's responsibility to evaluate whether specialized skill or knowledge is needed in assessing risks, applying audit procedures, or evaluating the results. Examples of specialists (other than IT specialists) that might be necessary in conducting an audit are not included in the proposed standard. We recommend that the Board include such examples in the final standard. Also, we recommend that the Board incorporate a reference to the existing guidance in AU 336, *Using the Work of a Specialist*, to address more comprehensively the auditor's consideration of using parties with specialized skills and knowledge.
2e	Paragraphs 18 – 20 – Paragraph 18 states that "the engagement partner should supervise other engagement team members…." Paragraph 19 states that "Supervision should include the following," and then provides a list. Paragraph 20 states that the level of supervision "should be appropriate for the circumstances…." We believe that creating multiple "should" statements and thereby imposing presumptively mandatory requirements is unnecessary in this instance. We believe that the initial "should" statement in paragraph 18 is sufficient to communicate the intended auditor behavior. We recommend that paragraphs 19 and 20 be revised to provide guidance on how to implement paragraph 18. For instance, paragraph 19 could be revised to begin with "Elements of effective supervision include….", and paragraph 20 could be revised to state that "the level of supervision of other engagement team members depends on many factors including…". If the "shoulds" are not removed from paragraphs 19 and 20, the language could be revised to clearly indicate the expected auditor response. It is unclear to us how an auditor could effectively and efficiently document that he or she has complied with the requirements of paragraphs 19 and 20. The above structure can be contrasted with paragraph 14, which we believe provides a good example of how to structure guidance and directs the action expected of an auditor. The first sentence of paragraph 14 contains the "should" statement in an actionable context.

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	Appendix 3: Identifying and Assessing Risks of Material Misstatement
3a	Paragraph 4 – The definition of significant risk in the proposed standard is different from that in the ISAs. The definition in the proposed standard does not refer to "identified and assessed" risks, but rather refers only to "risks." The resulting implications are unclear. We believe that the definition of significant risk should include the phrase "identified and assessed" risk. The entire concept of a "significant risk" in an auditor's risk assessment process is that the auditor identifies and then assesses that risk, and subsequently plans and performs audit procedures accordingly.
3b	Paragraph 10 – The proposed standard does not acknowledge that ongoing matters, in addition to significant changes, may affect the identification and assessment of risks of material misstatement. We recommend that the proposed standard be revised to acknowledge that ongoing matters (i.e., those matters that may have been significant in a prior year and are present in the current year) should be considered in the risk identification and assessment process.
3c	Paragraph 19 – We do not believe the Board's use of the term "transparency" relative to an auditor's responsibility to obtain an understanding of the application of accounting policies is sufficiently clear. We recommend that the Board either delete the reference to "transparency" of accounting policies, or provide further clarification of its expectations in this regard.
3d	Paragraphs 42 and 44 – The language in paragraphs 42 and 44 appears to describe substantive analytical procedures as opposed to preliminary analytical procedures, particularly in paragraph 44 which discusses "developing expectations." Also, paragraphs 6 through 8 of interim standard AU 329 provide valuable guidance to the auditor with respect to performing planning analytical procedures. However, those paragraphs are proposed to be deleted in the conforming amendments. We recommend that the PCAOB clarify that the expectations developed may be implicit in nature, particularly when performing preliminary analytical procedures, and consider retaining the guidance in paragraphs 6 thorough 8 of interim standard AU 329.

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3e	Paragraph 52 – Section d of paragraph 52 of the proposed standard indicates that inquiries of accounting and financial reporting personnel should be made with respect to whether "… accounting policies were appropriately or aggressively applied." We believe the Board should eliminate use of the term "aggressively". The use of this term is unclear and could lead to confusion on the part of auditors.
3f	Paragraph 56 (c) – The proposed standard states that the auditor should "evaluate the types of potential misstatements…" We recommend that the PCAOB incorporate the concept of "What could go wrong?" consistent with paragraph 30 of AS 5. We believe that consistent use of this terminology would enhance clarity and promote uniformity of execution.
3g	Appendix A – The reasons for this guidance appearing in an Appendix rather than the standard itself are unclear. Both paragraphs A1 and A4 contain presumptively mandatory obligations of an auditor. If Appendix A is intended to hold the same authority as the standard, it should be incorporated into the standard, particularly those paragraphs that contain presumptively mandatory obligations. We recommend that the Board incorporate the Appendix A guidance into the body of the standard, or remove the presumptively mandatory provisions embedded in Appendix A.

	Appendix 4: The Auditor's Responses to the Risks of Material Misstatement
4a	Paragraph 1 – The description in paragraph 1 omits a crucial element in responding to risk – the notion of the auditor's ***identification and assessment*** of the risk of material misstatement. We understand that the Board considered this matter and concluded that obtaining sufficient appropriate evidence to support the auditor's opinion requires the auditor to adequately respond to the risks of material misstatement. However, we do not believe that this approach appropriately makes the connection between the assessment of risk and the audit response. For instance, in each audit the auditor performs risk assessment procedures to determine where risks of material misstatement exist, and based on this assessment the audit response is designed and implemented to obtain sufficient appropriate evidence. The effectiveness with which this assessment is performed logically affects any audit response. By eliminating this connection between assessment and response, the standard would not explicitly require a linkage between the auditor's responses and the assessed risks of material misstatement. We believe that the notion of linkage is a fundamental concept of the audit risk process that enhances the quality of an audit. We recommend that the standard include the concept of linkage, that is, the auditor should design and implement appropriate responses based on the *identified and assessed* risks of material misstatements, which is consistent with ISA 330, *The Auditor's Responses to Assessed Risks.*

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4b	Paragraph 3 – We do not believe that the objective of the proposed standard is sufficiently descriptive to provide guidance that assists an auditor in achieving the requirements of the standard. We believe that the objective in the ISA 330 (redrafted) more clearly describes the auditor's responsibilities relative to responses to risks of material misstatement. Accordingly, we suggest replacing the phrase, "The objective of the auditor *is to address* the risk of material misstatement…" with the phrase, "The objective of the *auditor is to obtain sufficient and appropriate audit evidence…*" Furthermore, the phrase "through appropriate responses and audit procedures," does not clearly communicate the various actions necessary to address assessed risks, and therefore we suggest replacing such phrase with, "through designing and implementing appropriate responses to the assessed risks of material misstatement."
4c	Paragraph 4 – The proposed standard indicates that the auditor "should design and implement overall responses to address the risks of material misstatement as follows…", and provides a list of items. It is unclear what level of documentation is required of an auditor to meet the requirements of this paragraph. For example, an auditor might believe a memorandum to the file describing his or her judgments with respect to 'making appropriate assignments of significant engagement responsibilities' is required. We believe that the matters listed in paragraph 4 are routinely performed in practice by auditors and that imposing a 'should' requirement may likely create additional documentation requirements that may reduce audit efficiency without a corresponding increase in audit effectiveness. We recommend that the Board revise the proposed standard to eliminate these presumptively mandatory requirements, and clarify what actions are expected of the auditor.
4d	Paragraphs 14 – 15 – These paragraphs of the proposed standard relate specifically to audits of internal control over financial reporting. We believe that the inclusion of this information in the proposed standard may lead to confusion as to the requirements of the auditor in an audit of financial statements only. We recommend removing this guidance and retaining this guidance only in AS 5.

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4e	Paragraph 19 – The proposed standard contains a presumptively mandatory requirement whereby "tests of controls should be performed in the audit of the financial statements for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence…" To clarify the intent of this paragraph, we suggest including an example similar to that contained in ISA 330 (redrafted), which states that "In some cases…the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate evidence at the assertion level. This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. " Additionally, in paragraph 19, assessing completeness and accuracy is limited to substantive analytical procedures, but the auditor may need to test completeness and accuracy of data when performing other types of procedures, including tests of details. We recommend that the Board revise this paragraph to clarify its application, and the requirements imposed on the auditor.
4f	Paragraphs 14 – 39 – The guidance related to testing controls contained in paragraphs 14 through 39 appears to address testing controls in both an audit of financial statements only and in an integrated audit. It is not clear which guidance is applicable in a particular type of audit. A significant portion of this guidance also is included in AS 5. We believe that the requirements in this area could be clarified by removing integrated audit guidance that is included in AS 5.

	Appendix 5: Evaluating Audit Results
5a	Paragraph 3a – The proposed definition of "error" differs from the definition in both U.S. Generally Accepted Accounting Principles and International Financial Reporting Standards. We believe that the definition of an error should be determined by the accounting framework and that a separate definition is not necessary in the auditing literature. We believe the difference between fraud and error can be clearly delineated in the definition of "misstatement."

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5b	Paragraph 3b – The term "misstatement" appears to be defined using the concept of materiality. As currently written, the first sentence of the definition may be understood by some to be a statement of fact, or may be understood to be a definition of "material misstatement." To clarify, we believe that the term should be defined absent a reference to itself and absent the concept of materiality. A separate definition of material misstatement could be provided.
5c	Paragraph 19 – Regarding the evaluation of misstatements, the proposed standard uses the term "detected in prior years" instead of "related to the prior year." ISA 450 (revised and redrafted), paragraph 11 uses the term "related to the prior year". We believe the Board's proposed terminology does not address situations where misstatements are detected in the current year that relate to the prior year. We also believe the requirement does not accurately capture the requirements in Staff Accounting Bulletin 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements,* which provides guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement.
5d	Paragraphs 28 and 29 – These paragraphs of the proposed standard are included under the heading, *Assessing Bias in Accounting Estimates*. However, paragraph 28 deals with whether a misstatement exists in an accounting estimate, and not bias. Furthermore, this paragraph, on its own, is not sufficient to determine whether a misstatement in an accounting estimate exists. As written, these paragraphs may be more appropriately included in the section, "*Accumulating and Evaluating Identified Misstatements.*" With respect to paragraph 29, we understand that this requirement is similar to requirements in the Board's interim standards. However, we believe that ISA 540 (revised and redrafted) provides an auditor with valuable guidance relative to assessing potential bias in the financial statements that should be considered by the PCAOB. Although the proposed suite of risk standards address bias throughout, we believe that such standards lack application guidance with respect to the indicators of management bias and its effect on the audit. It would be helpful to clarify that, in addition to the fact that a misstatement due to fraud may exist, indicators of bias may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate, and whether the financial statements as a whole are free from material misstatement. Such guidance is particularly important in light of the requirement in paragraph 25 for the auditor to "assess" possible bias.

KPMG

	Appendix 6: Consideration of Materiality in Planning and Performing an Audit
6a	Paragraph 7 – The proposed standard uses the term "***reasonable investor***" when considering whether certain accounts or disclosures may carry more weight with financial statement readers. We believe "reasonable investor" is too limiting, as there may be users of the financial statements that are not investors. Other PCAOB standards, for example paragraph 91 of AS 5, as well as the ISAs (see ISA 320 revised and redrafted), utilize the term "user." We recommend that the Board revise the proposed standard to utilize the term "user."
6b	Paragraphs 8 and 9 – The proposed standard requires the auditor to determine the amount of "tolerable misstatement." Paragraph 9 of ISA 320 (revised and redrafted) uses the term "performance materiality" for essentially the same concept. We believe that these terms have the same meaning, and in order to promote consistency among the auditing standards, we recommend that the Board utilize the term "performance materiality" in the final standard.

PCAOB
Office of the Secretary
Keith Wilson, Associate Chief Auditor
1666 K Street NW Washington DC
202-207-9100   comments@pcaobus.org

Re   : The Auditor's Risk Assessment and Responsibility for Risk
Docket : 26
By   : Dr. Joseph S. Maresca CPA, CISA

Colleagues,

Thank you for the opportunity to critique the Auditor's Risk Assessment and Responsibility for Risk.

GENERALLY, the Statement seeks to articulate risk. i.e.

o the risk of expressing an inappropriate opinion when financial statements are materially mis-stated
o the risk to the entire audit due to material error et al. which the auditor fails to detect
o what could go wrong on the assertion level
o do the standards address the risk of fraud or material mis-statement

AUDIT PLANNING AND EVALUATION OF AUDIT RESULTS

CRITIQUE

The auditor must plan for the "what could go wrong" scenario so that there are no surprises.
Many things could go wrong in the arena of the auditee; namely,

o Key personnel could retire/resign leaving a significant learning curve with the attendant errors, downtime and the need for extensive training.
o Various Acts of G-d could necessitate the operation of the disaster recovery plan and/or contingency plans to restore operability.
o Host country expropriation could disturb the valuation process materially.
o The reversal of derivative risk could trigger major contingent liabilities which may be unanticipated or unfunded to date.
o The "VIX" index level could be higher than usual resulting in significant market gyrations

The "Comprehensive Approach" reviews both internal and external factors in the environment surrounding the auditor. The objective of the auditor is to keep audit risk to a low level for planning and audit supervision purposes. [p. 9/173]   In addition, the auditor must evaluate uncorrected mis-statements and control deficiencies in areas like recording transactions and the management of cash. The auditor may encounter problems in evaluating cash management when transactions are driven by computer algorithms. In these cases, the auditor must become familiar enough with the parameters of the computer program in order to understand the financial consequences of the automated cash management decision-making.

The audit process involves evidence - gathering and interpretation. The evidence may consist of a review of documents i.e. Letters of Credit , the testimony of management or experts   i.e. derivative excposures and real evidence like inventorying , physical counts of gold bars ... Ultimately, the auditor seeks to keep risks to a low level by exercising due professional care in the conduct of the audit. This task may be difficult in the review of transactions like derivatives since some transactions are bundled to transfer risk and others involve timing differences.

Inherent risk specifies the types of accounts , balances and contingencies susceptible to material mis-statement. The reversibility of derivative transaction risk is one of these areas. The way to guard against this type of error is for the legal counsel to draw up "air tight" contracts with respect to derivative transactions; such that, the rights, duties, obligations and remedies are set forth unequivocally.

The Sixth Circuit Court of Appeals interpreted the duties imposed on banks that market derivatives . After due consideration, the Court rejected a duty of appropriateness. The Opinion reinforces a basic tenet of the over-the-counter derivative markets. That is, swaps are principal to principal transactions so that end users have the responsibility for obtaining their own independent advisors to assist in evaluating proposed transactions. In essence, the Court said "Let the buyer beware ! "

Power and Telephone entered into interest rate swap agreements (rather loosely construed) in 1999 and 2000 with Sun Trust fixing a portion of the variable rate indebtedness. The swaps were favorable to Power and Telephone until interest rates dropped significantly during 2000- 2002. Power and Telephone's borrowing needs reduced and the company unwound the swaps in 2003. Power and Telephone filed a complaint against Sun Trust seeking millions in damages and asserting claims based on theories of breach of contract, agency, misrepresentation, negligence and a whole host of other assertions too numerous to list here.

Power and Telephone Supply Co. v. Sun Trust Banks, 2006
App. LEXIS 12087, 2006 FED APP. 166P (6th Circuit TENN. 2006)

Planning is an iterative process subject to considerable refinement at the beginning of the audit. Planning may consist of risk assessment procedures, substantive testing and other procedures iteratively. Auditing may occur at multiple locations so that the verification is tempered by security risks like Acts of G-d. A classic example is outsourcing in an area where there are ruinous contingencies like floods, Tsunamis, earthquakes etc. Although the arithmetic compilation of financial transactions may be correct and verifiable, other contingencies exist to disturb the current applicability of the audit findings or the reconstruction of business operations after a critical event.

Occasionally, experts in various disciplines may be engaged to opine on what constitutes real values in today's markets. For instance, an expert may be engaged to verify provable reserves for oil drilling purposes. New technologies exist to help structure decision-making where there is significant complexity and variable interpretation of the data.

Artificial intelligence systems are designed to optimize "advice giving" by a community of experts. The knowledge engineer elicits the advice from a well-defined community of experts in the art and places the comparative data on a knowledge base for future analysis and rule-making. Credit scoring is an area where "advice giving" systems may be useful optimally because the knowledge engineer seeks to establish the fairest mix of conditions precedent in order to make practical lending decisions based upon the collective experience of many experts .

Supervision is discussed on P. 25/173. A liaison is needed between the auditor and the Independent Audit Committee of the Board of Directors. The legal counsel must be engaged to explain host country legal issues outside of the auditor's domain of expertise. Examples of such areas are:

o host country venues for Courts to interpret the rights, duties and liabilities of the parties
o expropriation risk
o volatility of local markets , currencies and bourses
o comity principles
o the interpretation of major vendor contracts i.e. data processing, disaster recovery etc.

P. 35/173 should refer to the design of controls.

P. 37/173 discusses the IT Audit. The Statement should make reference to IT Security, record - retention of key data and files and contingency planning and testing of the plan.

P. 40/173 Artificial intelligence systems and advice giving systems should be referenced in order to obtain a comprehensive knowledge base for use by the entire client organization.
P. 62,3 should reference change control management to protect the integrity of the existing systems.

Dr. Joseph S. Maresca CPA, CISA

Mayer Hoffman McCann P.C.
An Independent CPA Firm
11440 Tomahawk Creek Parkway
Leawood, KS 66211
(913) 234-1000 ph
(913) 234-1100 fx
www.mhm-pc.com

February 18, 2009

CONFIDENTIAL
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

PCAOB Rulemaking Docket Matter No. 2008-026
Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendment to PCAOB Standards

Dear Members and Staff of the Public Company Accounting Oversight Board ("PCAOB" or "the Board"):

We appreciate the opportunity to provide our views on the *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendment to PCAOB Standards* (the "Proposed Standards"). We have reviewed the Proposed Standards and believe that such standards if adopted would result in improvements to the audits of issuers. We do however have certain recommendations and observations.

We note the efforts of the Board to eliminate unnecessary differences between the proposed standards and other risk assessment standards. We understand that the Board was unable to completely eliminate differences between the IAASB risk assessment standards and the proposed PCAOB standards. As you know, the AICPA as part of its clarity project has redrafted certain of its risk assessment standards in order to assist with the convergence of U.S. GAAS with the ISAs. We believe that it is in the best interest of the global financial markets as well as auditors and preparers to have a single set of auditing standards. We encourage the Board to work with the Auditing Standards Board ("ASB") and IAASB to minimize if not completely eliminate the number of differences between such standards. To the extent that differences between the various risk assessment standards remain prior to issuance of the Board's final risk assessment standards, we encourage the Board to retain the reconciliation of such differences appearing in Appendix 10 of the Board's proposed risk assessment standards and to expand the reconciliation to also explain differences between the PCAOB standards and U.S. GAAS.

We have observed that the PCAOB's proposed risk standards do not contain nearly the application guidance provided by the ASB's proposed risk assessment standards. We believe that application guidance and illustrative examples to support the requirements is helpful to auditors and promotes consistent application of principles. We encourage the Board to follow suit with the ASB in providing application guidance and illustrative examples that address compliance with the proposed requirements. We also encourage the Board to adopt the ASB and IAASB drafting convention of having distinct sections of the standards for Objectives, Requirements and Application Guidance. We are concerned that absent similar illustrative guidance from the Board, the ASB guidance will become the de facto standard because it is considered more "user-friendly".

We have considered the Board's intention to emphasize the auditor's responsibilities for considering the risk of fraud during an audit. We agree with the Board that the integration of the consideration of fraud into the risk assessment process is an improvement over past practice. We are concerned that financial statements users, the Plaintiff's Bar and other constituencies may incorrectly interpret the Board's prominent emphasis of the consideration of the risk of fraud in an audit as a higher degree of responsibility for auditors related to the detection and prevention of fraud. We encourage the Board to consider adding a statement to the proposed risk standards that clarifies that although the Board believes the changes set forth in the proposed consideration of fraud will likely prompt auditors to make a more thoughtful and thorough assessment of the risks affecting financial statements, (including fraud risk), the changes related to the auditor's consideration of the risk of fraud in an audit do not impart a new or higher level of responsibility than previously existed for the detection and/or prevention of fraud on the auditor.

Mayer Hoffman McCann P.C.

McGladrey & Pullen
Certified Public Accountants

McGladrey & Pullen LLP
Third Floor
3600 American Blvd West
Bloomington, MN 55431

February 20, 2009

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 026, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* and *Conforming Amendments to PCAOB Standards*

Dear PCAOB:

McGladrey & Pullen, LLP (McGladrey) appreciates the opportunity to offer our comments on the *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Conforming Amendments to PCAOB Standards*. McGladrey is a registered public accounting firm serving middle market issuers.

We support the Board's efforts to update its existing standards related to the requirements for assessing and responding to risks in an audit. We believe a risk-based approach for financial statement audits results in a more focused and effective audit, as well as one that is more efficient and scalable to companies of varying size and complexity.

Following are our comments that apply pervasively to the proposed standards, followed by specific comments on certain proposed standards.

<u>Eliminate unnecessary differences between the Board's risk assessment standards and other risk assessment standards</u>

Virtually all public accounting firms registered with the PCAOB also audit nonissuers. Unnecessary differences between the Board's standards and those for audits of nonissuers increase the costs of performing *all* audits because firms must develop and maintain dual audit methodologies and training programs. This also leads to confusion and misunderstanding by auditors of what is required of them and why, which potentially leads to an erosion of audit quality.

We believe these proposed standards are very similar to those of other standards setters, specifically the International Auditing and Assurance Standards Board's (IAASB) International Standards on Auditing (ISAs) and the AICPA's Statements on Auditing Standards (SASs), based on the same principles supporting a risk-based audit. However, we are concerned there are many differences between the proposed standards and the ISAs and SASs that are unnecessary, or where it is not clear whether the Board expects a different action by the auditor. For example, Appendix 6 (Proposed Auditing Standard – *Consideration of Materiality in Planning and Performing an* Audit) requires the auditor to reassess the established materiality level and tolerable misstatement as the audit progresses. The ISAs and SASs contain a similar requirement, based on the same principle, but stated using different words. It is not clear what type of different action, if any, the Board expects of the auditor. Another example is the use of terms in the proposed standards such as "should evaluate", "should determine" and "should assess," where the comparable requirements in the ISAs and SASs use terms such as "should consider." To the extent these different terms are intended to require a different level of performance and documentation, the differences and the purpose of such differences is unclear.

We recommend the Board use the same terms and language as found in the ISAs and SASs whenever it expects the same or similar action by the auditor. If a different action is expected, we urge the Board to clearly explain the different action expected so auditors understand what is required and the rationale for the difference.

We participated as a member of a task force assembled by the Center for Audit Quality (CAQ) to analyze these proposed standards and develop a comment letter reflecting the findings of the task force. The CAQ's comment letter contains other examples of unnecessary differences between the Board's standards and those of other standards setters with which we agree.

Exercise of sound professional judgment

There are several instances in the proposed standards where we believe requirements are overly prescriptive, which can result in inhibiting the auditor's use of professional judgment based on the unique facts and circumstances of each audit engagement. For example, Appendix 3 (Proposed Auditing Standard – *Identifying and Assessing Risks of Material Misstatement*), paragraph 52, is constructed so that the auditor "should include" specific individuals and topics for inquiries about fraud. We believe this requirement could impede the auditor's use of judgment to determine the best individuals to whom fraud inquiries should be directed and the matters to be discussed.
As another example, paragraph 27 of Appendix 3 requires the auditor to evaluate each control deficiency in the company's control environment to determine whether it is indicative of a fraud risk. While considering the impact of such control deficiencies on the auditor's fraud risk assessments is appropriate, we believe this requirement as stated is overly prescriptive and does not allow for the use of the auditor's judgment. Further, we believe this could lead the auditor to analyze each control deficiency individually, rather than considering them collectively and in light of other information.

Other examples are provided in the CAQ's comment letter to these proposed standards. We encourage the Board to use Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AS 5) as a model, which allows considerable use of auditor judgment through its top-down approach for determining which controls to test.

In addition, we support the recommendation in the CAQ's comment letter that the Board consider developing a new standard similar to ISA 200 that describes the underlying objectives of the auditor and that provides a foundation for the auditor's use of judgment throughout the audit.

Integration of the financial statement audit with the audit of internal control over financial reporting (ICFR)

In many cases, and especially in Appendices 3 (Proposed Auditing Standard – *Identifying and Assessing Risks of Material Misstatement*) and 4 (Proposed Auditing Standard – *The Auditor's Response to the Risks of Material Misstatement*, the proposed standards provide requirements and guidance for: (1) financial statement only audits, (2) audits of financial statements as part of an integrated audit, and (3) ICFR audits. In addition, AS 5 contains guidance that is relevant to financial statement only and integrated audits (for example, the use of the top-down approach and the identification of significant accounts and disclosures). We believe this format is confusing, and also suggests the risk assessment processes are different for different types of audits. We recommend the proposed standards be reorganized to support a single risk assessment process for all audits, including guidance currently in AS 5.

Integration with AU 316

We agree with the Board's approach to integrate certain requirements related to the auditor's consideration of the risks of fraud into the proposed standards. However, without a redrafted AU 316, it is difficult to analyze the Board's proposed changes. While we support the removal of "exculpatory language" from the existing AU 316, we believe the Board should retain as much as possible of the existing standard. We believe much of the guidance in existing standards is beneficial to auditors in implementing AU 316. A thorough and robust discussion about the nature and characteristics of fraud and the auditor's responsibilities for fraud enhances auditors' understanding of how to effectively implement the standard.

Finalization of standards

We support the Board's plans to issue a concept release in early 2009 indicating its plans to review its current interim standards, and we believe these proposed standards should not be finalized until the Board has exposed and received comments on that release.

Effective date of the standards

We encourage the Board to provide sufficient time between the issuance and effective dates of these proposed standards for firms to develop and execute an implementation plan, including revising their audit methodologies, software tools and quality control policies, and to develop and deliver training to audit personnel. We recommend that the standards be effective no earlier than audits of fiscal years beginning after December 15 of the year after the standards are issued.

Codification

We encourage the Board to undertake a project to provide a codification of its standards. A codification would result in a standardized form and style for all of the Board's standards, facilitating understanding of the standards, including amendments, by all users.

Standards-setting process

We encourage the Board to increase the openness and transparency of its standards-setting process. This can be achieved in a number of ways, including: (1) holding open meetings for discussion and debate of standards, (2) actively working with other standards setters to prioritize and coordinate agendas and to develop standards, and (3) providing detailed comparisons of the Board's proposed standards with comparable ISAs and SASs, as well as an explanation of why the Board decided to differ from those standards.

Increased openness and transparency will not only enhance auditors' understanding and timely implementation of the Board's standards, but it will also foster greater alignment of its standards with international auditing standards, as well as U.S. auditing standards for audits of nonissuers.

The following are our additional observations on specific paragraphs of the proposed standards:

a. Appendix 3 (Proposed Auditing Standard – *Identifying and Assessing Risks of Material Misstatement*), paragraph 22, second Note, last sentence requires that an inquiry of company personnel about whether a control has been implemented be combined with observation or inspection procedures. As such, the proposed standard does not allow for corroboration with a second inquiry. In certain cases, such as for controls related to management's commitment to ethical behavior, inquiries can be as or more effective than observation or inspection procedures for determining whether a control has been implemented; in other cases, inspection or observation procedures may not be practicable. We recommend that this proposed standard recognize that it may be appropriate to corroborate an inquiry with one or more additional inquiries. This is especially important in smaller companies where documentation of controls may be less formal.

b. Appendix 3 (Proposed Auditing Standard – *Identifying and Assessing Risks of Material Misstatement*), paragraph 39 states that if the auditor plans to modify the nature, timing or extent of risk assessment procedures based on information from prior audits, the auditor should determine whether prior year's information is relevant. While we agree with this comment, we suggest the Board provide additional guidance about the nature, timing or extent of risk assessment procedures needed for updating auditors' knowledge and information obtained in prior audits. We believe such guidance would improve audit efficiency, as well as the consistency and effectiveness of the risk assessment process for continuing audits.

c. Appendix 3 (Proposed Auditing Standard – *Identifying and Assessing Risks of Material Misstatement*), paragraph 62 refers to the risk of management override of controls. We suggest the Board consider providing guidance, such as that in paragraph 24 of AS 5, about the risk of management override of controls in smaller companies where there may be a lack of segregation of duties and where controls may be less formally documented.

d. Appendix 4 (Proposed Auditing Standard – *The Auditor's Response to the Risks of Material Misstatement*), paragraph 45 requires the auditor to perform tests of details in response to significant risks. We believe the approach in existing standards, which allows a combination of substantive analytical procedures and tests of controls in response to a significant risk is preferable.

We would be pleased to respond to any questions the Board or its staff may have about these comments. Please direct any questions to either Bruce Webb (515-281-9240) or Susan Menelaides (602-760-2827).

Sincerely,

McGladrey & Pullen, LLP

McGladrey & Pullen, LLP

CERTIFIED PUBLIC ACCOUNTANTS | BUSINESS CONSULTANTS

www.mossadams.com

T 206-302-6800
F 206-652-2098

February 18, 2009

SENT VIA EMAIL TO COMMENTS@PCAOB.ORG

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: Request for Public Comment: *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Conforming Amendments to PCAOB Standards*, PCAOB Rulemaking Docket Matter No. 026

Dear Office of the Secretary:

We appreciate the opportunity to share our views on the Public Company Accounting Oversight Board's (the Board or PCAOB) *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (the proposal or proposed standards).

Moss Adams LLP is the 11th largest accounting and consulting firm in the United States, and the largest headquartered in the West. Founded in 1913 and headquartered in Seattle, Washington, Moss Adams has 20 locations in Washington, Oregon, California, Arizona, and New Mexico. Our staff of over 1,900 includes more than 250 partners. Our audit practice emphasizes middle market, domestic and foreign-owned, public and private companies, as well as not-for-profit organizations.

In general, we support the Board's direction in updating public company auditing standards to reflect a more risk-based approach, and we agree with the basic principles of the proposed rules. We believe the approach described in the proposal is scalable, which is important to our varied client base of middle market public companies.

Further, we support the integration of fraud considerations as part and parcel of an audit risk assessment, and see advantages of retaining in a separate audit standard the specific required responses to fraud risk. This has the benefit of promoting integrated consideration of risk of material misstatement whether from fraud or error, while not diminishing the importance of specific fraud procedures and responses.

999 Third Avenue, Suite 3300
Seattle, WA 98104-4019

After reviewing the Board's proposal we believe additional clarification is needed in certain places. In other areas we see opportunities for more streamlined guidance that will assist the practitioner in the application of these proposed standards. Specifically, there are areas where we believe the benefits of divergence of the proposal from existing or proposed standards of other standard setters do not outweigh the costs of application. Our comments focus on:

- Convergence with other standards setters
- Integration with Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AS 5)
- Style of the proposed standards
- Codification of PCAOB standards

We also have observations about the PCAOB's standards-setting process and the effective date of the proposed standards.

Convergence with Other Standards Setters

While we support the incorporation of more clearly defined risk assessment principles into a public company audit, we encourage the Board to leverage as much as possible from existing standards adopted by other standard setting bodies, namely the International Auditing and Assurance Standards Board (IAASB) and the American Institute of Certified Public Accountants' Auditing Standards Board (ASB). While we agree there are areas in which the differences of a U.S. public company audit would warrant divergence from the standards adopted by the IAASB or the ASB, a higher degree of convergence than the PCAOB proposes would lead to higher quality and more efficient audits for all, including public company audits.

In a firm our size or smaller, the public company audit practice often represents a smaller part of the firm's client base, and as such the audit approach for the entire firm is not strictly designed around PCAOB standards. Rather, the requirements of PCAOB standards that are applicable only to public company audits are an addition to the firm's standard audit approach. It is difficult for a firm and practitioners to incorporate into their audit approach multiple sets of standards that vary from each other either slightly or completely, without a full understanding of the reasoning for the differences.

The Securities and Exchange Commission's (SEC) use of other standards setters (i.e., the Financial Accounting Standards Board) to establish the basis of public company accounting and the SEC's identification of areas where additional interpretation for public companies is warranted creates a common base of accounting principles, with clear identification of where public companies might diverge from private companies. We urge the PCAOB to consider a model similar to this. The result would be audit standards that are as similar as possible across all audits, with clear identification of what is different in a public company audit (whether an audit of financial statements only or an integrated audit). This would enhance auditors' understanding, implementation, and consistent execution of standards on all audits they perform, not just those subject to the PCAOB's oversight. This method also would allow the PCAOB to focus its efforts and resources providing guidance on the elements of an audit that are uniquely different for a public company audit, rather than re-creating the applicable elements of core audit standards.

There appear to be more similarities than differences between a risk-based audit as described by the proposed standards and that described by the ASB and IAASB standards. We suggest the Board use the International Standards on Auditing (ISAs) as a common base for current and future standards-setting, modifying them as it sees fit for a public company audit. The PCAOB indicated in its release of the proposal that it reviewed the application and other material in the ISAs, adapted those provisions that the Board believed are necessary for audits of issuers, and included them in the proposed standards. We recommend the Board be more transparent in that approach, clearly delineating what guidance it believes needs to be different for a U.S public company audit and the reasons. This explanation should encompass the Board's expectations for auditor actions that would be different than those required by the ISAs, particularly in areas where the PCAOB has specifically adopted mandatory or presumptively mandatory language where the ASB or IAASB has not. This would help the auditor understand whether a fundamentally different mindset is expected in performing a public company audit as opposed to one performed under Statements on Auditing Standards or ISAs.

Integration With AS 5

The proposed standards seem to imply there are separate risk assessment processes that would occur in an integrated audit – one for the audit of the financial statements and one for the audit of internal control over financial reporting. We believe the risk assessment process is fundamentally the same whether performing an audit of the financial statements only or an integrated audit. While the audit objectives and audit responses of each type of audit differ, the process to identify risks should be similar. The common element is the audit of the financial statements.

In that regard, we believe it is appropriate to create audit standards that comprehensively address risk assessment for a financial statement audit, and identify the incremental considerations, required procedures, and action steps for an audit of internal control. To increase the usefulness of the standards to practitioners we encourage the PCAOB to reconsider ways to better integrate into the proposed standards the relevant elements of existing guidance for performing an integrated audit.

We find that the Board's approach to combining content of the proposed standards with content of AS 5 is inconsistent and in some cases confusing. Our observations are summarized in three themes described below. The examples we provide are not intended to be an exhaustive list of the corrections we believe are needed, but we hope they will illustrate our observations and recommendations.

First, some **guidance from AS 5 that has relevance to an audit of financial statements (whether an audit of financial statements only or an audit of financial statements that is part of an integrated audit) is not incorporated into the proposed standards**. We recommend that this guidance be incorporated into the proposed standards. To the extent this incorporation creates redundancy, in keeping with our second observed theme below, we recommend that a conforming amendment eliminate the guidance from AS 5, or limit the guidance in AS 5 to only that which is incremental guidance applicable to an audit of internal control over financial reporting. Examples of this observation include:

- The notion of using a top-down approach is prevalent in AS 5, but is not incorporated into the proposed standards. We believe the top-down approach is equally relevant to identifying and responding to risk in a risk-based audit of the financial statements, and should be encouraged in the proposed standards to promote more efficient and effective audits of financial statements.
- Paragraph 11 of the proposed standard *Audit Planning and Supervision* provides guidance for multi-location engagements. Appendix B of AS 5 also contains multiple location scoping guidance, which we believe can be helpful in an audit of financial statements as well as an audit of internal control.

- Paragraph 6(b) of the proposed standard *Identifying and Assessing Risks of Material Misstatement* states that the auditor's risk assessment procedures should include obtaining an understanding of internal control over financial reporting. Understanding internal control is a focal point of the proposed standard, yet the auditor is referred to paragraph A5 of AS 5 for the very definition of "internal control over financial reporting" and a discussion of the inherent limitations of internal control over financial reporting. This important concept should be included within the proposed standard itself, not by reference to AS 5.

- AS 5 paragraphs 23-27, "Identifying Entity-Level Controls" include information on entity-level controls that we believe is also relevant in obtaining an understanding of internal control over financial reporting in an audit of financial statements only. We recognize the wording in AS 5 requires auditor action that would not be required in an audit of financial statements only, and that it is based on the underlying assumption that the operating effectiveness of internal controls will be tested to support the auditor's opinion on the effectiveness of internal control, which is a different audit objective than an audit of financial statements only. However, we believe much of the guidance in these paragraphs would be beneficial to an auditor of financial statements only as he or she obtains an understanding of the company's internal control over financial reporting. We recommend the Board incorporate the information in paragraphs 23-27 of AS 5 into the proposed standard *Identifying and Assessing Risks of Material Misstatement*, with modifications as appropriate, to fit the audit objective of an audit of financial statements only while not adding requirements for an audit of financial statements only.

- AS 5 paragraphs 34-36, "Understanding Likely Sources of Misstatement," present additional objectives the auditor should achieve in an integrated audit. As noted above, we believe the risk assessment process is fundamentally the same whether performing an audit of the financial statements only or an integrated audit. With respect to these paragraphs in AS 5, it is unclear what the Board intends to be different in a risk assessment performed in an integrated audit. We recommend the Board clarify what it intends to be different, or to appropriately incorporate the concepts in paragraphs 34-36 of AS 5 into the proposed standard *Identifying and Assessing Risks of Material Misstatement.*

- Paragraphs 37-38 of AS 5 discuss performing walkthroughs as a method of obtaining an understanding of controls. We believe this is equally beneficial guidance for the audit of financial statements only, and that the concept of walkthroughs should be added to the "Obtaining an Understanding of Internal Control Over Financial Reporting" section of the proposed standard *Identifying and Assessing Risks of Material Misstatement.*

- Paragraph 30 of AS 5 discusses the auditor's identification of significant accounts and disclosures and their relevant assertions, and suggests the auditor might ask "what could go wrong" with a given significant account or disclosure. We believe this is equally beneficial guidance for the audit of financial statements only, and that the concept of "what could go wrong" should be added to paragraph 56(c) of the proposed standard *Identifying and Assessing Risks of Material Misstatement.*

- Paragraph 37 of the proposed standard *The Auditor's Responses to the Risks of Material Misstatement* lists factors "the auditor should take into account" when determining the evidence needed in the current year audit to support the auditor's control risk assessments when controls have been tested in past audits. Paragraph 47 of AS 5 provides guidance on this topic for integrated audits. Paragraph 47 of AS 5 includes additional considerations we believe are equally relevant to an audit of financial statements only, and therefore should be included in the proposed standards. For instance, the complexity of the control, the significance of the judgments that must be made in its operation, the competence of the personnel performing the control from year to year, and the nature and materiality of the misstatements the control is intended to prevent or detect are important considerations in determining the extent of use of prior year audit evidence in an audit of financial statements only.

Second, we observed several instances of **unnecessary redundancy between the proposed standards and AS 5**. In these instances, guidance from AS 5 is repeated entirely or almost verbatim in the proposed standards, therefore duplicating guidance to be followed when performing an integrated audit. We believe such redundancy should be eliminated, as follows:

- Guidance from AS 5 that has been repeated in its entirety and is relevant to an audit of financial statements, whether or not that audit is part of an integrated audit, should be incorporated into the proposed standards and, through a conforming amendment, removed from AS 5 and replaced with a cross-reference to the proposed standards. An example of this observation is as follows:

- Paragraphs 21-24, 26-28 and 35 of the proposed standard *The Auditor's Responses to the Risks of Material Misstatement* are entirely copied from paragraphs 42-45, 50-51, 54, and 56, respectively, of AS 5. (In addition, paragraphs 25 and 32-34 of the proposed standard are modified slightly to accommodate a financial statement audit not integrated with an audit of internal control over financial reporting, but otherwise duplicate paragraphs 49, 53 and 55 in AS 5.)

- Guidance from AS 5 that has been incorporated into the proposed standards partially or with slight modifications to fit an audit of financial statements only should be retained in the proposed standards, and the duplicative parts removed from AS 5 through conforming amendments. In other words, the elements of the guidance that are common to audits of financial statements should be retained in the proposed standards, and AS 5 should be modified so that what is left in AS 5 is only the incremental guidance relevant to an integrated audit beyond what is considered necessary for an audit of financial statements only. Examples include:

    - The bullet points in paragraph 7 of the proposed standard *Audit Planning and Supervision* are incorporated, with very slight modification to broaden their scope to an audit of financial statements, from paragraph 9 of AS 5. There is very little difference in the two sources of guidance, so we recommend that a conforming amendment to AS 5 eliminate the redundancies. To the extent the Board intended there to be differences in the considerations applied in an integrated audit, those incremental differences should be clearly delineated and retained in AS 5.

    - AS 5 paragraph 9 states that "the auditor should properly plan the audit of internal control over financial reporting and properly supervise any assistants," but paragraph 3 of the proposed standard *Audit Planning and Supervision* states that "the auditor must adequately plan the audit and properly supervise the members of the engagement team." There is inconsistent use of "must" versus "should" and references to the engagement team. We believe the requirements embedded in the cited paragraphs for planning the audit and supervising members of the engagement team should be the same for an audit of financial statements only and an integrated audit. If the Board intended there to be differences, the common elements should be included in the proposed standards and the incremental requirements should be clearly delineated and retained in AS 5.

Third, **the proposed standards unnecessarily include guidance related only to an audit of internal control over financial reporting (and not to an audit of financial statements)**. Guidance that has no relevance unless the auditor is performing an audit of internal control should be eliminated from the proposed risk assessment standards and retained only in AS 5. Examples include:

- The Note to paragraph 34 of the proposed standard *Identifying and Assessing Risks of Material Misstatement* describes the auditor's understanding of control activities in an integrated audit in order to contrast it with that in an audit of financial statements only. The description of the nature of the auditor's understanding of controls in an integrated audit is unnecessary to the user of the proposed standard who is not performing an integrated audit, and we recommend the Board remove this Note to paragraph 34 from the proposed standard.
- The following paragraphs in the proposed standard *The Auditor's Responses to the Risks of Material Misstatement* should be removed because they pertain solely to an audit of internal control:
    - Paragraph 10 includes guidance that pertains to addressing fraud risk only in the audit of internal control.
    - Paragraphs 14 and 15 focus on testing controls specific to an audit of internal control. Additionally, paragraph 16 focuses on evidence about the effectiveness of controls in an audit of internal control.
    - Paragraph 31 pertains solely to the timing of tests of controls in an audit of internal control.
- Paragraphs 41 through 44 of the proposed standard *Evaluating Audit Results* unnecessarily repeat requirements and guidance existing in AS 5, and relate only to integrated audits. Because they have no relevance to the user of the proposed standards who is performing an audit of the financial statements only, and this guidance is already included in AS 5, we recommend these paragraphs be deleted from the proposed standards.

Style of the Proposed Standards

We believe that the structure of the proposed standards may unintentionally drive an auditor to use more of a checklist-oriented approach rather than a true assessment of risk and responsiveness to assessed risk. The overuse of presumptively mandatory requirements (i.e., use of the term "should") tends to take the focus away from an overarching risk-based audit objective and towards a list of required actions, which may or may not assist the auditor in achieving the overall objective. The reduction of presumptively mandatory requirements would also serve to streamline the proposed standards and direct the auditor to spend time where it is most needed – responding to identified and assessed risks.

We encourage the use of clearly stated objectives which provide the context for performing the requirements of each proposed standard. We also support clear separation of a stated requirement from its related application guidance. We recommend the Board more closely follow the format of the ISAs, which contain objectives, requirements, and related guidance in the form of application and other explanatory material. These components of each audit standard, clearly delineated, make it easier to apply the standards and focus on the overall objective.

We also encourage the Board to find areas of the proposed standards where guidance supporting a stated requirement is unnecessarily stated as a presumptively mandatory requirement using a "should" statement, therefore requiring specific action from the auditor. While in some places the proposed standards provide the appropriate amount of auditor flexibility (such as paragraph 15 of the proposed standard *Identifying and Assessing Risks of Misstatement),* the following are examples of what we believe are unnecessarily or overly prescriptive requirements:

- Paragraph 11 of the proposed standard *Audit Planning and Supervision* lists factors an auditor "should evaluate" regarding the selection of a particular location or business unit when multiple locations exist. We believe the presentation of a specific list of factors the auditor "should evaluate", requiring specific evaluation of each item, rather than presenting these factors as application guidance, discourages use of professional judgment and identification of other relevant considerations.

- Paragraph 18 of the proposed standard *Audit Planning and Supervision* establishes a requirement by stating "the engagement partner should supervise other engagement team members...." Paragraphs 19 and 20 provide detail on how the requirements stated in paragraph 18 should be fulfilled through additional "should" statements. The initial stated requirement in paragraph 18 is appropriate and sufficient to impose the requirement. We recommend that paragraphs 19 and 20 be presented as application guidance for paragraph 18.

- Paragraph 9 of the proposed standard *Identifying and Assessing Risks of Misstatement* is very prescriptive regarding how the auditor is to achieve the objective stated in paragraph 8. The detailed presumptively mandatory requirements may limit the auditor's appropriate use of his or her professional judgment. We recommend the items in paragraph 9 be presented as factors the auditor may consider in understanding the company.

- Paragraph 52(d) of the proposed standard *Identifying and Assessing Risks of Material Misstatement* requires the auditor to make specific inquiries about fraud of "accounting and financial reporting personnel, including, in particular, employees involved in initiating, authorizing, processing, or recording complex or unusual transactions." We agree that the inquiries that are required in paragraphs 52(a), (b), and (c) of management, the audit committee, and internal audit personnel, respectively, are appropriate, and that the auditor should make inquiries of others as he or she considers necessary in the circumstances. However, the proposed requirement to inquire of the personnel described in paragraph 52(d) could involve an impractical number of individuals, without corresponding benefit to the audit process.

In combination, the lack of clear overarching audit objectives in each standard (or for some proposed standards, no stated objective) and the inclusion of very detailed presumptively mandatory requirements contradict the PCAOB's stated recognition of the importance to the audit process of sound professional judgment. We believe the proposed standards should promote the use of auditor judgment to tailor the audit based on facts and circumstances of an individual audit to achieve stated audit objectives.

Finally, there is lack of consistency in how definitions and application guidance are presented in the proposed standards. Definitions are included in varying ways throughout each proposed standard, including within the text of the proposed standard, as an appended glossary, or in a separate section of the proposed standard. Similarly, application guidance appears in varying forms—within the text of the proposed standards, as an appendix, or as "Notes" to paragraphs of the proposed standards. The lack of consistency among the proposed standards makes it more difficult for the auditor to know what level of audit requirement is being put forth.

We recommend the Board consider imposing a consistent structure to its proposed standards that include a principles-based objective, specific requirements to achieve the objectives, and additional guidance that assists the auditor in fulfilling the objective, but does not create additional presumptively mandatory requirements.

Codification of PCAOB Standards

The Board's standards are becoming increasingly challenging and inefficient for practitioners to use. PCAOB Release No. 2008-006 states that the proposed standards will supersede five interim auditing standards (AU 311, AU 312, AU 313, AU 319, and AU 326). This will result in three separate types of PCAOB standards – the interim standards, Auditing Standards No. 1 through 6, and the new AU sections. As noted above, there is variety in the styles and structure among the seven proposed standards. There is even more variety when additional forms of existing PCAOB standards are considered.

We suggest a codification be provided so that practitioners are able to more readily navigate and apply the standards in a consistent manner. The codification should provide consistent identification of an objective, the stated requirements, and relevant application guidance. We believe this will improve the quality of audits. As the Board acknowledges, the principles set forth in the proposed standards are fundamental to the performance of a public company audit. As such, it is critical that the proposed standards be used as a foundation for the consistent integration of existing and future standards.

We also believe a codification would promote the integration of the audits of financial statements and internal control over financial reporting. Codification of PCAOB standards is likely to increase efficiencies when conducting an integrated audit (in part because it would mitigate the effect of the matters we note in the section titled "Integration with AS 5"), and allow for more consistent interpretation and application by practitioners.

PCAOB's Standards-Setting Process

We believe the PCAOB could improve its standards setting process by involving individuals with significant standards-setting experience and users of the PCAOB's standards earlier in the process. The input of these groups would result in a more effective and efficient process, and ensure that the majority of conflicts and implementation difficulties have been addressed and resolved in advance of exposure for public comment.

As noted above, we also believe the Board's process could benefit from leveraging more from the work already performed by the IAASB and use the ISAs as a common base for current and future standards-setting, modify as it sees fits for a public company audit. As noted in some of our comments above, it is unclear to us why the Board diverged from the ISAs with many of its requirements in the proposed standards. As noted above, we believe a more common base would allow for easier identification of differences, and fewer challenges to the auditor in applying the Board's standards to public company audits, resulting in higher quality audits.

Effective Date of the Proposed Standards

The PCAOB did not propose an effective date. In determining an appropriate effective date for the proposed standards, we encourage the Board to consider the need to provide sufficient time for firms to incorporate the standards into their audit methodology, develop or revise tools and documentation methods, and deliver training programs prior to implementation. The more divergent the final standards are from the standards of the IAASB and ASB, the longer the time should be to allow practitioners and firms to prepare. We believe at least 18 months is necessary between the adoption date and the effective date. In addition, due to the fundamental structural revisions we believe are necessary, we strongly urge the PCAOB to re-expose revised proposed standards, including a proposed implementation date, for public comment prior to adoption of the standards.

In summary, we appreciate the effort and time the Board and its staff have devoted to this proposal. While we believe the proposed standards are a step in the right direction of establishing risk-based audit standards for audits of public companies, we believe they require more consideration with respect to the areas outlined above. Above all, we believe audit standards that are of high quality and are as consistent as possible with those of other standards setters provide a common foundation for all audits and will result in better trained auditors applying auditing standards consistently, resulting in improved audit quality.

Thank you for the opportunity to comment on the proposed standards. If you have any questions on our response please contact Erica Forhan in our Professional Practice Group at 206-302-6826 or Erica.Forhan@mossadams.com.

Very truly yours,

Moss Adams LLP

Moss Adams LLP

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Home of the Trusted Professional
3 park avenue, at 34th street, new york, ny 10016-5991
212.719.8300 • fax 212.719.3364
www.nysscpa.org

February 11, 2009

Mr. J. Gordon Seymour
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

By e-mail: comments@pcaobus.org

Re: PCAOB Release 2008-006: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk; Proposed Conforming Amendments to PCAOB Standards (Rulemaking Docket Matter No. 026)

Comments on Proposed Auditing Standard – *The Auditor's Responses to the Risks of Material Misstatement*

Dear Mr. Seymour:

The New York State Society of Certified Public Accountants, representing 30,000 CPAs in public practice, industry, government and education, submits the following comments to you regarding the above captioned exposure draft. The NYSSCPA thanks the PCAOB for the opportunity to comment.

The NYSSCPA's Technology Assurance Committee deliberated the exposure draft, in particular Appendix 4, Proposed Auditing Standard – *The Auditor's Responses to the Risks of Material Misstatement*, page A4–13–37, and drafted the attached comments. If you would like additional discussion with us, please contact Bruce I. Sussman, Chair of the Technology Assurance Committee, at (973) 422-7151, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,
Sharon Sabba Fierstein
Sharon Sabba Fierstein
President

Attachment

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NYSSCPA
certified public accountants

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3 park avenue, at 34th street, new york, ny 10016-5991
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COMMENTS ON APPENDIX 4, PROPOSED AUDITING STANDARD – *THE AUDITOR'S RESPONSES TO THE RISKS OF MATERIAL MISSTATEMENT*, PAGE A4–13–37, OF PCAOB RELEASE 2008-006: PROPOSED AUDITING STANDARDS RELATED TO THE AUDITOR'S ASSESSMENT OF AND RESPONSE TO RISK (RULEMAKING DOCKET MATTER NO. 026)

February 11, 2009

<u>Principal Drafters</u>

Michael A. Pinna
Yigal Rechtman
Bruce I. Sussman

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Bruce H. Nearon
Yossef Newman
Joseph B. O'Donnell
Karina Pinch
Michael Pinch
Michael A. Pinna
Yigal Rechtman
Robyn Sachs
Walter Schmidt
Sheryl Skolnik
Inga Sokolova
Irwin Winsten

NYSSCPA Staff

Ernest J. Markezin
William R. Lalli

New York State Society of Certified Public Accountants

Comments on Appendix 4, Proposed Auditing Standard – *The Auditor's Responses to The Risks Of Material Misstatement*, Page A4–13–37, Of Proposed PCAOB Release 2008-006: Proposed Auditing Standards Related To The Auditor's Assessment Of And Response To Risk

The Society's Technology Assurance Committee deliberated page A4–13–37 of the proposed standard and has prepared the following comments. We wish to thank the PCAOB for the opportunity to comment.

Response Summary

The concept of benchmarking is one in which a baseline performance level for automated controls is established and then, in future years, auditors might not need to retest the effectiveness of that automated control in order to rely on it. However, reliance on the effectiveness of automated controls should not be based on the results of a previous audit. We believe that in today's complex information system environments, it is inappropriate to rely on benchmarking in an audit for the reasons discussed below. In addition, in circumstances where the auditor deems the information technology (IT) environment to be a significant internal control component, the environment should be tested every period. We believe that regular testing eliminates the need to use benchmarking as a control evaluation method.

Introduction

The automation of internal controls has become a substantial portion of the operations of companies large and small alike. Systems previously referred to as "Electronic Data Processing" (EDP) were serial in nature and simplistic in operation. Over decades, EDP systems have evolved into multi-platform, complex IT environments. Modern IT environments require auditors to obtain a thorough understanding and to perform a detailed analysis of EDP in order to be assured that such a system is well suited for the function it serves and that it operates as designed.

Discussion

Currently, automated controls are implemented by way of IT utilizing software, hardware, operating systems and "middle-ware." IT is a complex, multi-dimensional environment that no longer can be considered a simple "input-process-output" paradigm. Substantial detailed consideration and analysis need to be integrated within the attest procedures that assess the risks and operational effectiveness of an IT environment.

Benchmarking is generally the weakest strategy of the available alternatives for the evaluation of automated controls. Benchmarking is ineffective in many situations because most automated controls applications are key controls in the overall internal control environment. These key controls are often implemented as complex, multi-layered software or hardware applications. Such complex software is multi-modular and many factors affect the method by which the software receives, processes, stores, and outputs the information.

Automated controls that are implemented as complex software involve a large number of variables. Accordingly, each of these variables can affect the reliability of the control. The susceptibility of a control to ineffectiveness increases exponentially with the number of variables that are involved in its operations. The possibility exists that the passage of time may reveal that software which has been previously evaluated to be stable and reliable might contain variables and values unforeseen by the software designers and implementers that could adversely affect its reliability. For example:

a. In the late 1990s, many software vendors needed to re-write software code in order to accommodate a potential high-risk situation in which software would have treated the year 2000 as the year 1900. This scenario, known as "Y2K," could have affected controls that were previously effective in complex software environments. Therefore, the automated control that had been used for several decades could not withstand a certain set of values due to an unforeseen design limitation.
b. Automated software controls designed to calculate interest rates rounded to six decimal places used a memory format that allowed it to operate properly with interest rates that did not exceed 10%. However, when interest rates exceeded this limit, the same software that had been considered "mature and stable," failed to operate as designed.
c. Automated controls that were implemented assuming that three decimal places of accuracy were sufficient might not operate effectively when large market fluctuations require iterative calculations where a very large dollar amount is multiplied by a very small percentage. Because automated controls ultimately operate in a limited-memory universe, very precise floating point applications might fail when a combination of variables presents itself, leading to previously unanticipated errors.

In these examples, the effectiveness of the automated controls could vary based on arbitrary conditions which, without testing, would go undetected. In such circumstances, the automated controls would need to undergo and pass a change-management review, including appropriate testing. Reliance on previous results would lend a false sense of security and further steps would need to be taken in order to satisfy the audit requirements for establishing reliance on controls through testing.

Automated controls are closely linked to software implementation. Software design is not implemented in a vacuum; it must take into account the hardware, operating system and middle-ware that underlie the operation of the algorithm. Changes to the operating system, shared libraries from which the software applies certain common functions, drivers, and hardware can all affect the reliability of the software without advance warning. These unintended consequences occur because there is an inherit risk in the design of complex software systems. That risk is based on the method by which software is developed, i.e., the construct of operations. Machine language is abstracted into programming languages; programming languages are abstracted to programming libraries of re-useable code and libraries of code and abstract algorithms are used as high level tools to create complex software systems. Due to this level of abstraction, an inherit assumption exists for each level's code developer that the underlying levels would operate as designed. In fact, many times underlying levels, such as operating systems or shared libraries, do not operate as designed and seemingly innocent upgrades or updates might affect the reliability of the software adversely.

The concept of applying a benchmarking method to a control solely because it is believed to be "automated" gives rise to several concerns. Auditors would find it difficult to conclude that a modern IT environment which is automated to such a degree can be relied upon without testing. Further, applying a benchmarking method to a manual control would not comply with current audit standards. Accordingly, to propose allowing application of a benchmarking method of an automated control might be viewed as a contradiction of the applicable attest standards.

Benchmarking is an evaluation method that is most suitable to simple control environments in which serial operations are present. Such environments rarely persist because linear processing (input-process-output) is infrequently found in today's business environment. This linear processing has been replaced by control environments that are linked to complex IT environments. The marketplace expects that audit engagements will be able to address such complexities that include ever changing input definitions, processing parameters, and other factors. To that end, we believe that reliance on an automated control for which a low control risk had been assessed previously might result in the occurrence of a material misstatement and that the method might not satisfy external reviews or legal thresholds.

Conclusion

The standards should indicate that reliance on automated controls should be based on testing similar to that which is applied to non-automated controls. Reliance should not be placed on results from previous periods' testing without other testing being performed by the auditor.

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3 park avenue, at 34th street, new york, ny 10016-5991
212.719.8300 • fax 212.719.3364
www.nysscpa.org

February 18, 2009

J. Gordon Seymour, Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

By e-mail: comments@pcaobus.org

Re: PCAOB Release No. 2008-006 – Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk (PCAOB Rulemaking Docket Matter No. 026)

Dear Mr. Seymour:

The New York State Society of Certified Public Accountants, representing 30,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the above captioned exposure draft.

The NYSSCPA's Auditing Standards Committee deliberated the exposure draft and prepared the attached comments. If you would like additional discussion with us, please contact Robert N. Waxman, Chair of the Auditing Standards Committee at (212) 755-3400, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

Sharon Sabba Fierstein

Sharon Sabba Fierstein
President

Attachment

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certified public accountants

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3 park avenue, at 34th street, new york, ny 10016-5991
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PCAOB Release No. 2008-006
COMMENTS ON PROPOSED AUDITING STANDARDS RELATED TO THE AUDITOR'S ASSESSMENT OF AND RESPONSE TO RISK
(PCAOB Rulemaking Docket Matter No. 026)

February 18, 2009

Principal Drafters

Karin Blaney
Robert W. Berliner
Rosanne G. Bowen
Fred R. Goldstein
Jan C. Herringer
Menachem M. Halpert
Neal B. Hitzig
Anil Kumar
Moshe S. Levitin
Mark Mycio
Lawrence E. Nalitt
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Steven Wolpow
Anna Zubets

NYSSCPA Staff

Ernest J. Markezin
William R. Lalli

New York State Society of Certified Public Accountants

Auditing Standards Committee

Comments on

PCAOB Release No. 2008-006
Proposed Auditing Standards Related to
the Auditor's Assessment of and Response to Risk

The New York State Society of Certified Public Accountants welcomes the opportunity to comment on the PCAOB's *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (the proposed standards).

We support the PCAOB's efforts to improve the risk assessment procedures undertaken during an audit. We generally agree with the provisions of the proposed standards; however, we have the following comments for your consideration. Our comments are organized such that our overall observations on the proposed standards are presented, followed by responses to the specific questions posed in the PCAOB release. Further, we have included additional comments related to specific proposed standards when the specific questions did not sufficiently address our comments.

OVERALL COMMENTS FOR CONSIDERATION

Organization of the PCAOB Standards

We believe that the PCAOB standards should be structured so that all of the standards issued by the Board are consistent in style. For example, the proposed standards have objectives, while the existing standards do not. Additionally, some existing standards have terms defined in a separate "Glossary," some proposed standards have a "Definitions" section within the standard and other standards do not have any defined terms. The International Auditing and Assurance Standards Board (IAASB) and the AICPA Auditing Standards Board (ASB) are redrafting their auditing standards to promote greater clarity and more consistent application of their standards by auditors. We encourage the Board to undertake a similar project.

Use of Terms "Must" and "Should"

The use of the words "must" and "should" is not always consistent with their use in other PCAOB standards. For example, paragraph 9 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, states that "the auditor *should* [emphasis added] properly plan the audit of internal control over financial reporting and properly supervise any assistants," while paragraph 3 of the proposed standard *Audit Planning and Supervision* states "the auditor *must* [emphasis added] adequately plan the audit and properly supervise the members of the engagement team." We therefore recommend that the use of the terms "must" and "should" in the proposed standards be reviewed to ensure that their use is appropriate and their meaning is clear.

Use of Objectives

The PCAOB should consider how the objectives in the proposed standards are intended to be used. For example, according to paragraph 20 of International Standards on Auditing (ISA) 200 (Revised and Redrafted), *Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing*, the auditor should use the objectives in relevant ISAs to (a) determine whether any audit procedures in addition to those required by the ISAs are necessary to achieve the objectives stated in the ISAs, and (b) evaluate whether sufficient appropriate audit evidence has been obtained. We believe that the PCAOB should add objectives to all of its standards, and should provide a context for their use in a separate standard similar to ISA 200.

Standard Setting Process

We support the PCAOB's continued use of task forces with significant expertise to help compose drafts of auditing standards and we support the use of task forces in your efforts to obtain early public input from certain interested individuals or organizations prior to the formal public comment period. Early interaction with the public helps to achieve a more effective and efficient standard-setting process. We also support the continued participation of Board members and staff in joint task forces with the IAASB and the ASB. This participation aids the discussion and resolution of some of the more complex audit issues facing the Profession, and will help in reaching the goals of greater convergence of the Board's standards with the ISAs and Statements on Auditing Standards (SASs).

Requirements versus Application Guidance

In certain paragraphs of the proposed standards, we noted the ISA application guidance was elevated to requirements that we believe should be retained as guidance. Examples include:

- Paragraph 20 of the proposed standard, *Audit Planning and Supervision*, requires (through the use of the term "should") the level of supervision to be appropriate for the circumstances and lists certain factors. Given this presumptive requirement which is attached to a list of factors, it is unclear what action is intended as a result of such a requirement. We suggest that a better structure would be to require the auditor to plan the nature, timing and extent of the direction and supervision of engagement team members, and, as application guidance, to provide factors that may impact supervision. This structure would be similar to paragraph A15 of ISA 300, *Planning an Audit of Financial Statements*, and be treated as application guidance.

- Paragraph 12 of the proposed standard, *Identifying and Assessing Risks of Material Misstatement*, seems to require the auditor to obtain an understanding of specific listed characteristics of the nature of a company. These same characteristics, and others, are listed in the application guidance paragraphs A21-A22 of ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*.

Fraud Guidance
While we support the proposed standards' focus on the risk of fraud, we believe that the fraud guidance has been incorporated inappropriately in certain sections. For example, we believe that paragraph 13 of the proposed standard, *The Auditor's Responses to the Risks of Material Misstatements*, is redundant in that it requires the same procedures to address the risk of management override that are included in AU 316. We believe that the proposed standards should instead include references to other standards when necessary in order to eliminate the potential for inconsistencies or repetitiveness among different standards.

COMMENTS ON EACH OF THE PROPOSED STANDARDS

Audit Risk in an Audit of Financial Statements:

1. **Does the proposed standard appropriately describe audit risk and its component risks?**

   We believe that the proposed standard does appropriately describe audit risk and its component risks.

Audit Planning and Supervision:

2. **Is it reasonable and appropriate to extend the Auditing Standard No. 5 requirement regarding consideration of matters important to the audit of internal control over financial reporting to audits of financial statements?**

   It is reasonable and appropriate to extend the Auditing Standard No. 5 requirement regarding consideration of matters important to the audit of internal control over financial reporting to audits of financial statements because the planning and risk assessment process is the same for an integrated audit as it is for an audit of financial statements.

3. **Is the direction regarding multi-location engagements reasonable and appropriate?**

   We believe that the direction regarding multi-location engagements is reasonable and appropriate.

4. **Is more direction needed regarding multi-location engagements? If so, in what areas is additional direction needed?**

We do not believe that more direction is necessary regarding multi-location engagements.

5. **Are the responsibilities of the engagement partner for planning and supervision appropriate and reasonable, and is the proposed direction clear?**

   ISA 300, *Planning an Audit of Financial Statements*, further describes the role of the engagement partner and other key members of the engagement team in paragraphs A5 and A9. The responsibilities of the engagement partner in the proposed standard could be further clarified if guidance similar to these paragraphs were included in the proposed standard.

Additional Comments on *Audit Planning and Supervision*:

We believe it is neither appropriate nor necessary for objectives in individual standards to contain the terms "must" or "should." Such words should be reserved for the requirements that support the objectives of the standards. Accordingly, we recommend that paragraph 3 of the proposed standard be moved from the "Objective of the Auditor" section of the proposal and incorporated as requirements under the "Planning an Audit" and "Supervision" sections of the proposed standards.

Paragraph 10 states, "the auditor should develop a written audit plan." However, the term "written" can be misleading in the age of electronic work paper documentation. As such, we recommend that the Board revise this paragraph to state, "The auditor should develop an audit plan, which should be documented electronically or in writing and should include a description of…"

We believe it would be helpful to auditors to include a footnote in paragraph 13 that references the extant guidance in AICPA Professional Standards, Volume 1, AU 336, *Using the Work of a Specialist*, to address the auditor's consideration of using individuals with specialized skills and knowledge. We further believe that such a footnote should include examples of specialists (other than Information Technology (IT) specialists) who might be necessary in conducting an audit or refer to examples of specialists who are listed in AU 336.

Identifying and Assessing Risks of Material Misstatement:

6. **Does the proposed standard clearly and adequately describe the auditor's responsibilities for performing risk assessment procedures?**

   The proposed standard does clearly and adequately describe the auditor's responsibilities for performing risk assessment procedures.

7. **Are the additional procedures in paragraph 13 that the auditor should consider performing when obtaining an understanding of the company and its environment reasonable and appropriate for audits of issuers? Should**

these procedures be specifically required for all audits, or is the responsibility to consider performing the procedures sufficient?

The additional procedures are reasonable and appropriate. We agree that the requirement to consider performing the procedures is sufficient.

8. **Is the new requirement to assess certain matters related to the control environment component of internal control over financial reporting reasonable and appropriate? Is the difference between the required performance for an audit of internal control over financial reporting and an audit of financial statements only clear?**

   The requirement to assess certain matters related to the control environment component of internal control over financial reporting is reasonable and appropriate. Additionally, the difference between the required performance for an audit of internal control over financial reporting and an audit of financial statements only is clear.

9. **Is the additional direction regarding the period-end reporting process reasonable and appropriate for audits of financial statements only?**

   The additional direction is reasonable and appropriate.

10. **Are the requirements and direction regarding the auditor's responsibilities for evaluating design and implementation of controls as part of obtaining an understanding of internal control over financial reporting sufficient and clear? If not, what additional direction is needed?**

    The requirements and direction is sufficient and clear.

11. **Does the additional description of the key engagement team members provide a better understanding of the expected participants in the discussion?**

    The additional description of the key engagement team members does provide a better understanding of the expected participants in the discussion.

12. **Does the discussion of significant risks in this standard provide sufficient direction to enable auditors to identify significant risks?**

    The discussion of significant risks in this standard provides sufficient direction to enable auditors to identify significant risks.

13. **Should the proposed standards include specific requirements and direction regarding documentation, e.g., summaries of the identified and assessed risks and the linkage to the auditor's responses?**

We do not believe the standards should include specific requirements and direction regarding documentation.

***The Auditor's Responses to the Risks of Material Misstatement*:**

14. **Does the proposed standard clearly describe the auditor's responsibilities regarding tests of controls in integrated audits and in audits of financial statements only?**

    The proposed standard does describe clearly the auditor's responsibilities regarding tests of controls.

15. **Are the requirements and direction regarding tests of controls appropriately aligned with Auditing Standard No. 5?**

    The requirements and direction regarding tests of controls are appropriately aligned with Auditing Standard No. 5.

16. **Does the proposed standard clearly describe the auditor's responsibilities regarding substantive procedures?**

    The proposed standard does describe clearly the auditor's responsibilities regarding substantive procedures.

Additional Comments on *The Auditor's Responses to the Risks of Material Misstatement*:

We believe paragraph 50 should be re-worded as follows: "If the auditor *discovers* misstatements that he or she did not expect when assessing the risks of material misstatements, the auditor...." We further believe that because of its importance, this paragraph should follow paragraph 41 (and that all subsequent paragraphs should be renumbered).

Evaluating Audit Results:

17. **Does the proposed standard clearly describe the auditor's responsibilities regarding the evaluation of audit results?**

    The proposed standard describes clearly the auditor's responsibilities regarding the evaluation of audit results.

18. **Are the requirements and direction regarding the accumulated identified misstatements and evaluating uncorrected misstatements appropriate and adequate?**

The requirements and direction regarding accumulating identified misstatements and evaluating uncorrected misstatements are appropriate and adequate.

19. **Are the requirements and direction regarding the evaluation of the results of the integrated audit appropriately aligned with Auditing Standard No. 5?**

    The requirements and direction regarding the evaluation of the results of the integrated audit in this proposed standard are appropriately aligned with Auditing Standard No. 5.

Consideration of Materiality in Planning and Performing an Audit:

20. **Are the requirements and direction in this standard appropriately aligned with the concept of materiality as described in the courts' interpretation of the federal securities laws?**

    The requirements and direction in the proposed standard appear consistent with the courts' interpretation of the concept of materiality. Materiality should be based on the "users" of the financial statements and the proposed standard clearly indicates that the surrounding circumstances and the "users" of the financial statements should be considered when determining materiality.

21. **Does the proposed standard sufficiently and clearly describe the auditor's responsibilities regarding (a) establishing an appropriate materiality level for the financial statements as a whole and (b) establishing a lower materiality level or levels for particular accounts or disclosures? If not, what additional direction is needed?**

    The proposed standard sufficiently and clearly describes the auditor's responsibilities regarding establishing appropriate materiality levels.

22. **Is the use of the term "tolerable misstatement" in the proposed standard appropriate and sufficiently clear?**

    The use of the term "tolerable misstatement" is not sufficiently clear because the term is only referenced in paragraph 8 of the proposed standard to paragraph 18 of AU Sec. 350, *Audit Sampling*. The definition of "tolerable misstatement" should be clearly explained in this section and the reference to paragraph 18 of AU 350 should be removed.

Additional Comments on *Consideration of Materiality in Planning and Performing an Audit*:

In the note to paragraph 3, we believe that the last sentence, "However, it ordinarily is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors" should be removed because we believe that it is practical to design audit procedures to detect material misstatements based solely on qualitative factors.

Audit Evidence:

23. Does the proposed standard clearly describe the principles necessary for evaluating the sufficiency, relevance, and reliability of audit evidence?

Certain paragraphs should describe more clearly the principles necessary for evaluating the sufficiency, relevance, and reliability of audit evidence. For example, the third bullet in paragraph 8 states, "Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly." The proposed standard does not explain the term "indirectly." We believe the proposed standard should either clarify the term or provide examples of the types of evidence that are obtained indirectly.

Additionally, paragraph 29 of the proposed standards addresses situations in which inconsistent audit evidence is obtained or an auditor questions the reliability of audit evidence obtained. The guidance in paragraph 29 is inconsistent with the guidance in paragraph 9. For example, paragraph 29 directs the auditor to assess the effect, if any, on other aspects of the audit. Such guidance, however, is omitted from paragraph 9.

24. Are the auditor's responsibilities regarding the authentication of documents reasonable and appropriate?

Paragraph 9 of the proposed standards addresses this issue and, in our opinion, needs additional guidance. We believe that if an auditor determines that "a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor," the auditor should follow the guidance in the auditing standards for the discovery of possible misstatements or illegal acts. We believe that the proposed guidance in this paragraph advising the auditor to "modify the planned audit procedures or perform additional audit procedures to respond to those conditions," does not convey to an auditor the potential seriousness of this matter sufficiently and would not provide adequate guidance for the circumstances described.

25. Are the requirements and direction related to selecting items for testing appropriate and clear?

Additional guidance should be provided for addressing the selection process for the completeness assertion.

26. Are the five categories of assertions in this standard sufficient or should they be expanded? If so, how would such expansion affect auditor performance?

The Society believes that the proposed standard should be expanded to the 13 categories used in ISA 500, which are the same categories used by the AICPA, as they are more precise and complete. The five original categories do not adequately represent the assertions implicit in dynamic information (classes of transactions and events for the period) and in disclosures.

Additional Comments on *Audit Evidence:*

Paragraph 12 states the following:

> *The auditor may base his or her work on assertions that differ from those in this standard if:*
>
> *a. In the audit of financial statements, the assertions are sufficient for the auditor to identify the types of potential misstatements and appropriately respond to the risks of material misstatement in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated, and*
>
> *b. If the audit is an integrated audit of the financial statements and internal control over financial reporting, the auditor has selected and tested controls over the pertinent risks in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated.*

The meaning of subparagraph b. is unclear. Specifically, this paragraph does not explain how testing controls as part of an integrated audit changes the nature of the relevant assertions. Subparagraph b. implies that assertions were indirectly addressed through control testing—not that they are different assertions. The intent of subparagraph b. should be clarified.

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PricewaterhouseCoopers LLP
400 Campus Dr.
Florham Park NJ 07932
Telephone (973) 236 4000
Facsimile (973) 236 5000
www.pwc.com

February 18, 2009

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket No. 026, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* and *Conforming Amendments to PCAOB Standards*

Dear Sir:

We appreciate the opportunity to respond to the Public Company Accounting Oversight Board's (PCAOB or the "Board") *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* and *Conforming Amendments to PCAOB Standards* (the "standards," "proposed standards" or "proposals").

Identifying, assessing and responding to risks are integral to the audit process and fundamental to the conduct of high quality, effective and efficient audits. We concur with the Board that risk assessment, appropriately applied, should underlie the entire audit process and result in audit procedures that are tailored to a company's facts and circumstances, including its size and complexity. We therefore support the Board's objective to update its existing interim standards to reflect improvements that firms have made in risk-based audit methodologies. We also appreciate the Board's efforts to consider recommendations on potential ways to further improve risk assessment (e.g., the 2000 report by the Panel on Audit Effectiveness, and feedback from the PCAOB's Standing Advisory Group (SAG)). Some of these same recommendations served as the impetus for the AICPA's Auditing Standards Board (ASB) and the International Auditing and Assurance Standards Board (IAASB) to form a joint task force in 2001 that culminated in the development of a common set of risk assessment auditing standards intended to improve audit quality and to support convergence of auditing standards.

We acknowledge the challenge of drafting risk assessment standards that provide sufficient direction to the auditor to identify, assess and respond to risk appropriately, yet do not impede the necessary exercise of professional judgment on which a risk-based audit depends. It is critical that auditors use sound professional judgment to identify and address those risks that, if not addressed, affect the auditor's ability to obtain reasonable assurance that the financial statements are free from material misstatement. It is also important, however, to balance the need for a thorough risk assessment process with one that gives appropriate consideration to the attendant cost-benefit considerations. Auditors must be able to make judgments about the severity of the risks identified so that the level of effort to respond to each risk is commensurate with its significance to a particular audit. We believe that improvements can be made to the proposed standards to better address these considerations.

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In the remainder of our letter, we have organized our overall observations and concerns about the proposal into the following topical areas:

- Convergence of auditing standards
- Importance of auditor application of professional judgment
- Importance of the linkage between assessed risks and the auditor's response
- Risk assessment process: consistency and integration with Auditing Standard No. 5 (AS 5)
- Organization and content of standards
- Integration of fraud guidance
- Considerations related to the finalization of the proposed standards

In addition, we have provided comments and recommendations regarding codification of the PCAOB's standards and increased public involvement in the PCAOB's standard-setting process, particularly through the use of task forces with representatives from the auditing profession and by participation in task forces with other standard setters.

Finally, we have included our specific comments for each of the proposed standards and the conforming amendments in the Appendix to this letter.

Convergence of Auditing Standards

We fully support the Board's consideration of the work of other standard setters, as evidenced by the overall alignment of the proposal's general structure with the corresponding risk assessment standards of the IAASB and the ASB. We also recognize the efforts of the Board to participate in the work of other standard setters by PCAOB staff attending and participating in IAASB meetings, inviting the IAASB Chairman to join the SAG meetings, and participating in joint meetings of standard setters.

While significant steps have been taken, the PCAOB can achieve even greater benefits by more fully implementing the objective in its 2008-2013 strategic plan to "participate in the work of, and engage with, other standard-setting bodies to benefit from, and as appropriate incorporate, new developments and techniques to promote high quality audits worldwide." In particular, we encourage the Board to consider using the International Standards on Auditing (ISAs) as the base from which to develop its standards, as other national standard setters are doing, and add to or modify the ISA wording for requirements and guidance only as the Board deems necessary for audits, including integrated audits, of issuers. We also encourage the Board to work together with other standard setters to eliminate unnecessary differences and achieve greater convergence of standards.

Increased convergence of high-quality auditing standards has the potential to elevate the consistency of the quality of audits performed worldwide, including those performed in accordance with the PCAOB's standards. A more collaborative approach among standard setters will enhance the effectiveness and efficiency of standard-setting processes; improve the global understanding of auditing standards both by auditors and by other interested parties; eliminate unnecessary differences among the standards; and clarify the rationale for and understanding of differences that remain, such as those necessitated by an integrated audit performed for legal or regulatory reasons. These benefits will enhance auditors' understanding, implementation, and consistent

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application of standards on *all* audits they perform, including those subject to the Board's oversight. Additionally, appropriate convergence allows firms to avoid adding unnecessary costs to audits, for example, by allowing for synergies related to training, implementation, and the development and maintenance of quality control systems that provide reasonable assurance regarding compliance with the standards of the various standard-setting bodies.

We acknowledge and support the Board's published analysis of significant differences between its proposed standards and those of the corresponding ISAs. In this regard, we agree with the following remarks made by Board member Bill Gradison at the Board's October 21, 2008 open meeting:

> "For the first time, the PCAOB is putting out a new standard for comment that includes an extensive comparison of its proposal with the standards promulgated by another standard setter, in this case the Risk Assessment Auditing Standards of the International Auditing and Assurance Standards Board – the so-called ISAs. I would hope that the PCAOB would continue to put out such comparative information in connection with future proposals for new PCAOB standards. We are fast entering an auditing environment with three differing standards, especially as the PCAOB gradually replaces its interim standards (the pre-2003 ASB standards) and the ASB revises its standards, using the ISAs as the base – that is, "ISAs plus." I don't know whether over the long run having three standards is sustainable, but as long as there are three standards I believe each standard setter has a responsibility to make it as clear as possible how its standards differ from those of the other two standard setters so that practitioners know what is expected of them. Today's Board action is, in my mind, a constructive step in that direction."

In light of the increasing global acceptance of the ISAs, we encourage the Board to provide a more detailed comparison of its proposed standards and those of the IAASB. This could be achieved, as recommended above, by starting with the comparable ISA in developing the Board's standards to facilitate more robust comparison of the standards and to clearly identify where, and why, the Board believes divergence from the ISAs is necessary.

Our detailed comments in the Appendix to this letter identify areas in which we believe greater convergence could be achieved without jeopardizing the Board's objective to issue robust standards directed to audits, including integrated audits, of issuers.

<u>Importance of Auditor Application of Professional Judgment</u>

We acknowledge and agree with the Board's statement in its release accompanying the proposed standards of the importance to the audit process of auditors' exercising sound professional judgment to determine how best to fulfill the requirements of the proposed standards under particular circumstances. We also acknowledge the Board's statement in paragraph A19 of the appendix to Auditing Standard No. 3, *Audit Documentation*, that "….because professional judgment might relate to any aspect of an audit, the Board does not believe that an explicit reference to professional judgment is necessary every time the use of professional judgment may be appropriate." While not disagreeing with the Board's prior conclusion, we nonetheless believe it is particularly important to acknowledge the need for the auditor's professional judgment within these proposed standards which establish the fundamental principles of the audit and rely on the use of professional judgment to appropriately apply the standards to the unique circumstances of each audit engagement. It is important to recognize that the judgments made regarding the identification and assessment of risks; the nature, timing and extent of audit procedures to address those risks; and what constitutes sufficient evidence are necessarily dependent on the facts and circumstances known to the auditor during the conduct of the engagement. Although such judgments are

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particularly susceptible to second-guessing, the concept of a risk-based audit is dependent on the exercise of professional judgment.

In addition, we believe some presumptively mandatory requirements in the proposed standards are unnecessarily prescriptive and could have the unintended consequence of encouraging a checklist approach rather than promoting the exercise of professional judgment to appropriately scale and tailor the risk assessment process, and the related audit response, in each audit.

Importance of the Linkage between Assessed Risks and the Auditor's Response

We note that the linkage between the auditor's assessment of risk and the performance of audit procedures responsive to that risk—one of the more significant improvements resulting from the IAASB's and ASB's reconsideration of performing a risk-based audit—has not been incorporated into the proposed standards. The linkage between the assessment of risk and the audit response is a fundamental concept in performing a risk-based audit. We understand that a deficient risk assessment should not be used as justification for an inadequate audit; however, there doesn't seem to be a purpose for assessing risk if the outcome doesn't drive the auditor's response. Without an appropriate assessment of and response to risk, the auditor may not obtain sufficient evidence when there is a higher risk of misstatement (resulting in an ineffective audit) or perform work unnecessarily when the risk of misstatement is low (resulting in an inefficient audit). We recommend that the proposed standards incorporate the concept of linkage, that is, the auditor should design and implement appropriate responses based on the *identified and assessed* risks of material misstatements, which is consistent with ISA 330, *The Auditor's Responses to Assessed Risks.*

In particular, incorporation of the term and concept of "assessed risks" throughout the standards, as has been done in the ISAs, would address this concern and make clear the important linkage between identifying and responding to risks. Further, we believe that the objectives in the proposed standards, *Identifying and Assessing Risks of Material Misstatement* and *The Auditor's Responses to Risks of Material Misstatement,* should be aligned with those in the comparable ISAs to acknowledge this linkage.

Risk Assessment Process: Consistency and Integration With Auditing Standard No. 5 (AS 5)

We encourage the Board to reconsider ways in which to better integrate its guidance for performing an integrated audit, including the consideration of audit risk in an integrated audit (see overall comment in the Appendix on the proposed standard *Audit Risk in an Audit of Financial Statements*). We understand that the proposed standards are intended to be suitable for audits only of financial statements as well as for integrated audits. However, we find that the Board's approach to combining the proposed standards with Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements* (AS 5), is inconsistent and in some cases potentially confusing. Our long-standing views about the need to provide integrated risk assessment guidance for the integrated audit were articulated by Ray Bromark, then the leader of PwC's National Office, when the PCAOB first discussed "Risk Assessment in Financial Statement Audits" at its February 16, 2005 SAG meeting. Specifically, Mr. Bromark observed the following:

> "…now that we have moved to an integrated audit and reporting on the effectiveness of an internal control system, I think that changes the dynamic a fair amount on what risk it is we're assessing…as we move the mentality from financial statement audits to integrated audits, I think it's incredibly important that we expand our thinking in the area of risk assessment to the integrated audit."

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Notwithstanding the different objectives of the audits (i.e., identification of material misstatements versus identification of material weaknesses), we believe that in an integrated audit the risk assessment process is generally the same for both the audit of the financial statements and the audit of internal control over financial reporting (ICFR). The fundamental requirements to obtain an understanding of the entity, including its internal control, and its inherent risks as a basis for assessing the risk of material misstatement are applicable in both the financial statement and ICFR audits. Once the risks of material misstatement have been identified and assessed, the auditor's *responses* to those risks may differ depending on whether an integrated audit or a financial statement only audit is performed. We are concerned that the Board's proposed risk assessment standards may encourage a "side-by-side," rather than an integrated, approach to risk assessment for auditors performing an integrated audit.

For example, the guidance about the auditor's understanding of the components of internal control in the proposed risk assessment standards should be better aligned with related guidance in AS 5. In particular, AS 5 paragraphs 34-38, "Understanding Likely Sources of Misstatement," and paragraphs 22-27, "Identifying Entity-Level Controls" are different from the guidance on understanding the components of internal control in *Identifying and Assessing Risks of Material Misstatement*. The differences suggest that a parallel rather than an integrated understanding is necessary to identify and assess risk in the audit of ICFR and the financial statement audit.

In addition, there is considerable redundancy between guidance in the proposed standards and that in AS 5. Such redundancy should be eliminated as it may also create confusion. If guidance in AS 5 is equally relevant to an audit only of financial statements, it should be incorporated into the risk assessment standards and replaced in AS 5 with a cross-reference to the risk assessment standards. An example of such guidance is paragraph 7 of the proposed standard *Audit Planning and Supervision* which is incorporated from paragraph 9 of AS 5. In contrast, there is guidance incorporated from AS 5 in the proposed risk assessment standards that would be relevant only when the auditor is performing an integrated audit. In such circumstances, the guidance should remain in AS 5 and the risk assessment standards should include only a cross-reference. An example of such guidance is paragraphs 41-44 of the proposed standard *Evaluating Audit Results*.

Finally, there is a significant inconsistency between the risk assessment proposals and AS 5 in that the "top-down approach" permeates AS 5, but is not mentioned in the proposed standards. We believe that the top-down approach is also relevant to the audit of the financial statements and should be addressed by the Board in the proposed standards.

Organization and Content of Standards

Objectives

We support the inclusion of a principles-based and outcome-oriented objective in each of the proposed standards. If objectives are going to be introduced to PCAOB standards, however, the PCAOB should consider from the outset how the objectives of individual standards are intended to fit into the overall framework of PCAOB standards. In the ISAs, for example, objectives of individual standards are intended to assist the auditor in planning and performing the audit to achieve the overall objectives of the audit as set forth in ISA 200. As stated in paragraph 20 of ISA 200, the auditor should use the objectives in relevant ISAs to (a) determine whether any audit procedures in addition to those required by the ISAs are necessary in pursuance of the objectives stated in the ISAs, and (b) evaluate whether sufficient appropriate audit evidence has been obtained. The Board should consider adding objectives to all of its standards, not just the seven in the proposal, and similarly link them to overarching guidance that provides context for their use.

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We do not believe it is appropriate for objectives in individual standards to contain the words "must" or "should" governed by the Board's Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*. Such words should be reserved for the requirements that support the objectives of the standards. Accordingly, we recommend that paragraph 3 of the proposed *Audit Planning and Supervision* standard be removed from the "objective of the auditor" section of that proposed standard.

Finally, we believe that some objectives proposed by the Board are overly broad (e.g., those in *Evaluating Audit Results* and *Audit Evidence*) and the linkage between others should be improved (e.g., *Identifying and Assessing Risks of Material Misstatement* and *The Auditor's Responses to the Risks of Material Misstatement*).

Appropriate balance between requirements and guidance

While we generally support the brevity of the proposed standards, there are some areas in which the proposal would be improved with additional explanatory guidance, some of which is included in extant PCAOB, IAASB or ASB standards. For example, paragraph 19 of the proposed standard *The Auditor's Responses to the Risks of Material Misstatement* requires the auditor to perform tests of controls "for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence," but the proposed standard provides no guidance to explain when such circumstances arise. The Board should consider including guidance about when this is the case. For example, we believe this is the case under circumstances where a significant amount of information supporting financial statement assertions is electronically initiated, recorded, processed, or reported, as described more fully in paragraphs A120-121 of ISA 315 (Redrafted), *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment.* In such cases, the entity's controls over such risks are relevant to the audit and the auditor should obtain an understanding of them. This guidance is also included in paragraphs 119-120 of AICPA AU 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* and in paragraphs 68-69 of the Board's interim standard AU 319, *Consideration of Internal Control in a Financial Statement Audit*.

We also believe that some of the guidance in the proposed standards is unnecessarily prescriptive and will reduce efficiency without a commensurate increase in effectiveness.

For example, paragraph 52(d) of the proposed standard *Identifying and Assessing Risks of Material Misstatement* which requires the auditor to make specific inquiries about fraud of "accounting and financial reporting personnel, including, in particular, employees involved in initiating, authorizing, processing, or recording complex or unusual transactions" is unnecessarily prescriptive, and may result in an extensive volume of inquiries. We suggest that the proposed standard retain the auditor's ability to apply judgment in determining those with whom such discussions are appropriate, which is more consistent with the current guidance in AU 316.25 and paragraph A16 of ISA 240. We agree that the inquiries that are required in paragraphs 52(a), (b), and (c) of management, the audit committee, and internal audit personnel, respectively, are appropriate; however, we believe that the requirement in 52(d) is an unnecessary elevation of guidance.

Inconsistent use of terminology: *"should consider," "should evaluate" and "should assess"*

We observed numerous instances in the proposed standards (for example, paragraphs 41 and 63 in *Identifying and Assessing Risks of Material Misstatement* and paragraphs 4 and 25 in *Evaluating Audit Results*) in which the Board changes "should consider" guidance drawn from its interim standards or from the ISAs to "should evaluate" or "should assess" guidance. We believe "should consider" provides appropriate direction to auditors in these cases. If the PCAOB decides that it is

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necessary to make these changes, the PCAOB should clarify whether the auditor's response and level of documentation are expected to be different under the proposed standard. If not intended to be different, we recommend that the Board restore the "should consider" terminology.

Definitions

We encourage the Board to develop and follow a consistent approach with respect to defining terms. Some of the proposed standards (for example, *Identifying and Assessing Risks of Material Misstatement*) define terms in a Definitions section similar to the redrafted ISAs. Others define terms informally within the text of the standard (for example, the definition of fraud risk in paragraph 4(c) of *The Auditor's Responses to the Risks of Material Misstatement*). AS 5 demonstrates a third approach with a Glossary of defined terms appended to the standard. These differences in approach make the standards more difficult to use and could lead to misunderstanding. We recommend that the Board define terms in a special Definitions section of each standard, as appropriate, and create a Glossary with all defined terms.

Use of notes to paragraphs and appendices

We do not understand the purpose for including Notes within paragraphs of the Board's standards. We recommend that guidance currently in Notes be incorporated into existing or new paragraphs. In addition, to the extent that appendices are used, we recommend that they not include requirements. Requirements should be included in the text of the standard.

Integration of Fraud Guidance

We believe that there are pros and cons to the integration of AU 316, *Consideration of Fraud in a Financial Statement Audit,* into the proposed standards. For firms that already integrate the consideration of fraud throughout the audit process, such as ours, this proposed integration is not likely to result in a significant change to the existing approach. However, the PCAOB's integration of fraud guidance may be of benefit to those practitioners who view fraud procedures as a "bolt on" to other audit procedures rather than as an integrated consideration throughout the audit. Therefore, we believe that the extent of benefit resulting from the proposed integration will be dependent on an auditor's existing approach to fraud procedures.

A potential downside of the proposed integration is that the guidance on fraud is dispersed throughout several standards, which may make it more difficult to obtain a holistic understanding of how the auditor should address the risk of fraud than if the guidance were retained in a single standard.

Considerations Related to the Finalization of the Proposed Standards

Overall review of interim standards

We support the Board's intent, announced at its October 2008 SAG meeting, to issue a concept release for public comment in early 2009 addressing the Board's action plan for review of its interim standards. We question, however, whether issuance of this concept release would have been more appropriate prior to, or simultaneous with, the exposure of the proposed risk assessment standards. Due to the fundamental nature of the proposed standards, we suggest that the Board consider feedback on the concept release in connection with making revisions to these proposed standards prior to adoption.

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Effective date

We note that the proposed standards do not include an effective date. We believe the Board should expose the proposed implementation date for public comment prior to issuance of the standards. We encourage the Board to consider the need to provide sufficient time for firms to incorporate the standards into their audit methodology and to implement related training programs prior to the beginning of the year in which the proposed standards would apply.

Codification of the PCAOB's Standards

We acknowledge the Board's efforts to write standards that will serve as a foundation for future standard setting. However, we have difficulty envisioning how these standards will be integrated with the Board's other interim standards and with Auditing Standard Nos. 1 through 6.

Further, adoption of the proposed standards will introduce a third "style" of standard that is inconsistent with the Board's other standards, as previously discussed under Objectives and Definitions in the "Organization and Content of Standards" subsection of this letter. We are unclear how the Board anticipates integrating the various styles in the future. The IAASB and the ASB have both undertaken projects to redraft all of their auditing standards in a consistent manner, with the expectation that this exercise will improve understanding and lead to more consistent application by auditors and, as a result, improve audit quality. We encourage the Board to undertake a similar project to introduce greater consistency and clarity in its standards.

Public Involvement in the Standard-Setting Process

We encourage the Board to increase the depth and accelerate the timing of public involvement, including the auditing profession, in its standard-setting process. We believe that this can be done effectively without compromising the independence of the Board's standard-setting process. We acknowledge the important role that the Board's SAG and its inspection process play in informing the Board's agenda. We also support the remarks of Board Member Dan Goelzer, at the PCAOB's October 21, 2008 open meeting, that the Board might consider additional steps to promote the transparency of the Board's process. Mr. Goelzer suggested potential actions such as publishing a revised proposal, opening a second comment period and holding additional public forums or Board discussions to consider the comments.

While the above recommendations would improve transparency, the quality of the standard-setting process could be significantly enhanced by creating task forces or otherwise more directly involving experienced members of the auditing profession in the development of standards. We envision task forces comprised of experts, including members of the auditing profession, who would deliberate working drafts of auditing standards and provide input to the Board and its staff for consideration during the development stage, prior to the publication of a proposed standard for public comment. We believe that such a process would enhance the quality, timeliness and efficiency of the development process and complement the role of the SAG and the other forums that currently inform the Board's standard-setting activities.

We also encourage Board members and PCAOB staff to participate in joint task forces with the IAASB and the ASB. In that regard, we strongly support the following views expressed by Bill Gradison to the Colorado Society of CPAs on December 19, 2008:

> "…if one sees merit in the quest for a single high-quality set of auditing standards (as I do), or if one sees this as inevitable for the protection of investors in our interconnected world (as I also do), then the challenge is for the three standard setters to develop a road map – a systematic, joint, comprehensive standard-by-standard review…. seeking at

PRICEWATERHOUSECOOPERS

least to eliminate unneeded differences among the present standards and in addition exploring in the interest of investors the adoption of a single set of high-quality internationally accepted auditing standards."

* * * * *

We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have. Please contact Vin Colman (973-236-5390), Jorge Milo (973-236-4300) or Brian Croteau (973-236-4345) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP

Attachment

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APPENDIX

Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* and *Conforming Amendments to PCAOB Standards

This appendix provides our detailed comments specific to each of the seven proposed standards and the conforming amendments to PCAOB standards for the Board's consideration.

Appendix 1: *Audit Risk in an Audit of Financial Statements*

Overall

In Appendix 9, the Board asks if the proposed standard appropriately describes audit risk and its component risks. We encourage the Board to obtain additional input, perhaps via a task force involving representatives of the profession and academia or via a public forum, to explore how the audit risk model might be updated in light of the integrated audit. The fundamental nature of the concepts in this proposed standard make it particularly important that similarities and differences between audit risk in a financial statement only audit compared to an integrated audit are addressed. Among other matters, we suggest the Board consider updating the definition of audit risk for an integrated audit to include the risk that the auditor expresses an inappropriate audit opinion on internal control over financial reporting when there is a material weakness in internal control over financial reporting.

In addition, the discussion of the component risks—particularly detection risk—should be reconsidered in the context of the financial statement audit and updated to address the audit of internal control over financial reporting. We note that the first sentence in paragraph 10 of the proposed standard states that "the level of detection risk is reduced through the performance of substantive procedures." For the auditor performing an integrated audit, the performance of substantive procedures informs the audit of internal control over financial reporting, but the risk that a material weakness remains undetected is primarily reduced by performing tests of controls. For the auditor performing an audit only of financial statements, we believe that the sentence should be deleted or clarified. Many auditors perform a combined assessment of inherent and control risks (i.e., a combined assessment of the "risks of material misstatement"), which is the approach taken in the IAASB and ASB standards as well as an acceptable approach in the Board's extant interim standard (AU 312.31). When making a combined assessment, the auditor's detection risk is affected by tests of controls and risk assessment procedures as well as by substantive procedures.

Appendix 2: *Audit Planning and Supervision*

Overall

References to an integrated audit or the audit of internal control over financial reporting are limited to paragraph 7 and a Note in paragraph 11. The guidance in this standard is equally applicable to integrated audits which could be recognized more clearly by incorporating the phrase "whether performing an audit only of the financial statements or an integrated audit" in key paragraphs such as paragraphs 5, 8, 10, 13, and 18.

Paragraph 3

- We do not believe that objectives should include unconditional or presumptively mandatory requirements. We suggest that the paragraph either be deleted or split into two

PRICEWATERHOUSECOOPERS

APPENDIX

unconditional requirements, one on planning which would precede paragraph 4 under the subhead "planning an audit," and the other on supervision, which would precede paragraph 18 under the subhead "supervision."

- The statement that "the auditor *must* [emphasis added] adequately plan the audit and properly supervise the members of the engagement team," is inconsistent with paragraph 9 of AS 5 which states that "the auditor *should* [emphasis added] properly plan the audit of internal control over financial reporting and properly supervise any assistants." We recommend that the Board eliminate inconsistencies in the use of these terms.

Paragraph 7

- The bullet points in paragraph 7 repeat those in paragraph 9 of AS 5 unnecessarily. We believe the guidance in paragraph 7 is equally relevant to an audit only of financial statements as it is to an integrated audit. We recommend that the guidance in the proposed standard be retained and that paragraph 9 in AS 5 be replaced with a cross reference to this guidance. Such a change will encourage audit integration through integration of the standards.

  We also recommend including in paragraph 7 of the proposed standard the Note to paragraph 9 of AS 5 which provides useful guidance concerning companies with less complex operations. Footnote 8 to the 4th bullet point of paragraph 12 in Appendix 3, *Identifying and Assessing Risks of Material Misstatement*, should then be changed to refer back to paragraph 7 of this proposed standard rather than to AS 5.

- Several of the bullet points in paragraph 7 (i.e., the first, fifth, and ninth bullets), while important to the auditor's understanding of the company, are not intrinsically important to the company's financial statements and internal control over financial reporting. Accordingly, we recommend clarifying the introduction to the bullet points as follows:

  > When developing the audit strategy and audit plan as discussed in paragraphs 8-10, the auditor should evaluate whether the following matters are important to ***the auditor's understanding of*** the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures.

Paragraph 9

- In paragraphs 9(b) and 9(c), the auditor "should determine" matters that the auditor following paragraph 7(c) and (d) of ISA 315 "should consider." We believe "should consider" provides appropriate direction. If not adopted, the PCAOB should clarify whether the auditor's response and level of documentation are expected to differ under the proposed standard.

- We suggest changing the wording in paragraph 9(b) to "Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts" to conform to paragraph 7(c) of the ISA, which is clearer.

PRICEWATERHOUSECOOPERS

APPENDIX

Paragraph 10

- We recommend that the Board replace the phrase "develop a written audit plan" in this paragraph with "develop and document an audit plan" to be more consistent with Auditing Standard No. 3, *Audit Documentation*, which clarifies in paragraph A3 that "audit documentation may be in the form of paper, electronic files, or other media."

Paragraph 11

- The factors that an auditor "should evaluate" in this paragraph are factors that the auditor "should consider" in existing PCAOB interim standard AU 312.18. We believe "should consider" provides appropriate direction. If not restored, the PCAOB should clarify whether the auditor's response and level of documentation are expected to change under the proposed standard.

- The Note in this paragraph directs the auditor performing an integrated audit to paragraphs B10-B16 of Appendix B of AS 5 for incremental guidance on scoping decisions in multilocation audits. We believe some aspects of the guidance in paragraphs B10-B13 are also relevant for an audit only of financial statements and should be adapted as necessary, moved to this standard, and replaced in AS 5 with a cross-reference to this standard.

- We suggest inserting "consolidated" before "financial statements" in paragraph 11(c).

Paragraph 12

- We recommend replacing the words "or the discovery of a previously unidentified fraud risk" with the words "or the discovery of a previously unidentified risk of material misstatement due to fraud (fraud risk)" to clarify the meaning of "fraud risk" and to be consistent with paragraphs 28(a) of Appendix 3, 4(c) of Appendix 4 and 5(d) of Appendix 5.

Paragraph 15

- We believe that the guidance in paragraph 15 applies to all specialists and not just those with IT skills. Therefore, we suggest modifying the introductory sentence preceding the bullet points to: "if an individual with specialized ~~IT~~ skill or knowledge employed or engaged by the auditor's firm participates in the audit, the auditor should have sufficient ~~IT-related~~ knowledge to enable the auditor to…" This is consistent with paragraph 11 of the ASB's proposed standard *Planning an Audit* (Redrafted).

Appendix 3: *Identifying and Assessing Risks of Material Misstatement*

Overall

Unlike AS 5, the proposed standard does not discuss the use of a top-down approach as part of identifying and assessing risk. We believe that the top-down approach is also fundamental to the process of identifying and assessing risks of material misstatement of the financial statements. We recommend that the Board address the top-down approach in this proposed standard.

In addition, guidance about the components of internal control in this proposed standard should be better aligned with related guidance in AS 5. There are differences in the way that controls are

PRICEWATERHOUSECOOPERS

APPENDIX

described in the two standards which suggest that a parallel rather than an integrated understanding is necessary to assess risk in the audit of internal control over financial reporting and in the financial statement audit. In particular, AS 5 paragraphs 34-38, "Understanding Likely Sources of Misstatement," and paragraphs 22-27, "Identifying Entity-Level Controls" could be better integrated with the discussion of internal control in the proposed standard.

Paragraph 3

- In order to reinforce an important linkage between assessing risk and audit response, we recommend that the Board adopt the objective in ISA 315, as follows:

  > The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion level, through understanding the entity and its environment, including the entity's internal control, *thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement* [emphasis added].

Paragraph 4

- We believe the PCAOB definition of significant risk should include the reference in the ISA definition to "identified and assessed risk," as shown below, rather than just "risk." The auditor first identifies risk, and then assesses that risk, followed by a need to plan the audit procedures accordingly. We therefore think “identified and assessed risk" is more accurate relative to the risk assessment process.

  > Significant risk—An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

  If the Board decides to retain the term "important enough" in the phrase "a risk of material misstatement that is *important enough* to require special audit consideration," the Board should provide guidance to clarify the meaning of "important enough."

Paragraph 5

- We do not believe that "obtaining sufficient appropriate audit evidence" is a meaningful concept solely in the context of identifying and assessing risk. We recommend rewording paragraph 5 as shown below:

  > The auditor should perform risk assessment procedures to ***provide a basis for the identification and assessment of*** ~~obtain sufficient appropriate evidence to identify and appropriately assess~~ the risks of material misstatement due to error or fraud and to design further audit procedures.

Paragraph 6

- We recommend narrowing the scope of paragraph 6(c) to "other engagements ***performed by the engagement partner for the entity***," consistent with ISA 315 paragraph 8. Particularly on large global audits, it is not practical to expect the auditor to assess information obtained on all engagements performed by the audit firm for the client.

PRICEWATERHOUSECOOPERS

APPENDIX

- We suggest that the PCAOB consider repeating the AS 5 definition of internal control over financial reporting, including the related discussion of the inherent limitations of internal control over financial reporting, in this proposed standard and then deleting footnote 5 to paragraph 6(b).

Paragraph 12

- When considered with paragraphs 8 and 9b, this paragraph may be overly prescriptive regarding the auditor's performance related to each of the bulleted items in the list. While we acknowledge that each of these items can be important to consider, we believe that they should be presented as examples to allow the auditor to scale and tailor the audit. For example, the requirement to obtain an understanding of "the relative profitability of key products and services" as part of understanding sources of the company's earnings is more relevant in some situations than others.

Paragraph 13

- In order to preserve the ability to exercise professional judgment, the items identified in this paragraph should be characterized as application guidance that the auditor may perform, consistent with ISA 315. Some of these items are overly broad ("reading public information about the company" with no qualifiers as to source) while others are too granular to apply every year for all public company engagements ("obtaining information about significant unusual developments regarding trading activity in the company's securities"). We believe this is an example of overly prescriptive guidance that favors a checklist approach and inappropriately limits the exercise of professional judgment.

Paragraphs 16-17

- We recommend clarifying the guidance on performance measures. Application guidance from paragraphs A32-A36 of ISA 315 may provide source material. In particular, the meaning of the second bullet point in paragraph 17 is unclear.

Paragraph 19

- Paragraph 19 requires the auditor to obtain an understanding of various matters related to the company's selection and application of accounting principles, including "the financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles." We question whether in creating this requirement the Board has considered limitations in the auditor's ability to do this in a first-year audit or when the client has new personnel.

Paragraph 21

- Footnote 12 at paragraph 21 refers to paragraph 13 of AS 5 which discusses scaling the audit. The guidance in paragraph 13 is equally relevant to the auditor performing an audit only of the financial statements and should be included in this proposed standard.

Paragraph 32

- Paragraph 32 unnecessarily duplicates guidance in AS 5 regarding the period-end financial reporting process. We believe the guidance in paragraph 32 is equally relevant to an audit

PRICEWATERHOUSECOOPERS

APPENDIX

only of financial statements as it is to an integrated audit. We recommend that the Board replace the second sentence (including the bullet points) of paragraph 26 in AS 5 with a cross reference to paragraph 32. Also, we recommend deleting the Note to paragraph 32 and adding the following as the last sentence: "Paragraphs 26-27 of Auditing Standard No. 5 include guidance on evaluating the period-end financial reporting process in an integrated audit."

Paragraph 40

- A requirement in existing PCAOB standards that the auditor "should consider" whether information from the results of interim reviews is relevant when identifying risks of material misstatement in the year-end audit has been changed to a requirement that the auditor "should evaluate" that information. We believe "should consider" provides appropriate direction. If not restored, the PCAOB should clarify whether the auditor's response and level of documentation are expected to change under the proposed standard.

Paragraph 41

- A requirement in paragraph 8 of ISA 315 that the engagement partner "should consider" whether information obtained from other engagements performed by the engagement partner for the entity is relevant to identifying risks of material misstatement has been changed to a requirement that the auditor "should assess" that information. We believe "should consider" provides appropriate direction. If not adopted, the PCAOB should clarify whether the auditor's response and level of documentation are expected to differ under the proposed standard.

- We recommend narrowing the scope of paragraph 41 to "other engagements performed by the ***engagement partner*** ~~auditor~~," consistent with ISA 315 paragraph 8. Particularly on large global audits, it is not practical to expect the auditor to assess information obtained on all engagements performed by the audit firm for the client.

Paragraph 52b

- We are unclear as to the difference between the auditor's inquiries regarding the audit committee's views about the risks of fraud as included in paragraph 52(b)(1) and those included in paragraph 52(b)(4), and suggest that additional clarification be provided.

Paragraph 52d

- We believe the requirement for the auditor to make specific inquiries about fraud of "accounting and financial reporting personnel, including, in particular, employees involved in initiating, authorizing, processing, or recording complex or unusual transactions" is unnecessarily prescriptive, and may result in an extensive volume of inquiries. We suggest that the proposed standards retain the auditor's ability to apply judgment in determining those with whom such discussions are appropriate, which is more consistent with the current guidance in AU 316.25 and paragraph A16 of ISA 240.

Paragraph 54

- PCAOB paragraph 54 requires that the auditor "should assess who might reasonably be expected to have information that is important to the identification and assessment of fraud

PRICEWATERHOUSECOOPERS

APPENDIX

risks," which has been changed from the requirement in extant AU 316.24 that "the auditor should use professional judgment to determine those others within the entity to whom inquiries [about the existence or suspicion of fraud] should be directed and the extent of such inquiries. In making this determination, the auditor should consider whether others within the entity may be able to provide information that will be helpful to the auditor in identifying risks of material misstatement due to fraud..."

We believe that the requirement in paragraph 54, which follows requirements to make specific inquiries about fraud of management (52a), the audit committee or its chair (52b), internal audit (52c), and accounting and financial reporting personnel, including, in particular employees involved in initiating, authorizing, processing, or recording complex or unusual transactions (52d), inappropriately suggests that the others to whom inquiries should be directed is susceptible to an objective assessment based on what "might reasonably be expected" (i.e., if hindsight reveals that the auditor didn't identify the "right" person to whom to direct such inquiries, the auditor's assessment was deficient).

Paragraph 56

- The Note to the 5th bullet point in this paragraph refers the reader to paragraphs 28-33 of AS 5 for additional discussion of identifying significant accounts and disclosures and their relevant assertions. We recommend incorporating 28-33 in this proposed standard and replacing it in AS 5 with a cross reference to this standard.

Paragraph 57

- This paragraph refers the auditor performing an audit of internal control over financial reporting to paragraph 34 of AS 5 which sets forth certain objectives that the auditor should achieve to further understand the likely sources of potential misstatement and as part of selecting the controls to test. We believe some of the guidance in paragraphs 34-38 of AS 5 is relevant in an audit only of financial statements and would be particularly helpful when the auditor intends to rely on controls to alter the nature, timing and extent of substantive procedures. We encourage the PCAOB to consider how paragraphs 34-38 of AS 5 may be adapted and incorporated into this proposed standard.

Paragraph 63

- In determining which risks are significant risks, ISA 315.27 includes factors that the auditor "shall consider" whereas the proposed standards includes factors that "should be evaluated." We believe "should consider" provides appropriate direction. If not adopted, the PCAOB should clarify whether the auditor's response and level of documentation are expected to differ under the proposed standard.

Appendix A

- Paragraphs A1 and A4-A6 in the Appendix contain presumptively mandatory responsibilities. We believe that requirements should be limited to the body of standards and should not appear in Appendices.

PRICEWATERHOUSECOOPERS

APPENDIX

Appendix 4: *The Auditor's Reponses to the Risks of Material Misstatement*

Paragraph 3

- We recommend that the Board adopt the objective in ISA 330, as follows, in order to reinforce the important linkage between assessing risk and audit response:

  The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

Paragraph 10

- Paragraph 10 is unnecessarily repetitive with paragraph 14 of AS 5. We recommend replacing it with the following:

  When planning and performing the audit of internal control over financial reporting ("audit of internal control"), the auditor should refer to paragraphs 14-15 of AS 5 for guidance.

Paragraph 11

- We recommend editing the guidance in paragraph 11 to read "In the audit of the financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the ***identified*** fraud risks" to align with the guidance in paragraph 14 of AS 5 that "the auditor should evaluate whether the company's controls sufficiently address *identified* fraud risks…[emphasis added]"

Paragraphs 14-16

- Because these paragraphs are relevant only when the auditor is performing an integrated audit, we suggest they be deleted from the proposed standard and replaced with a reference to AS 5.

Paragraph 19

- This paragraph requires the auditor to perform tests of controls "for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence" but provides no guidance to explain when such circumstances may arise. We recommend that the Board consider including guidance about when this is the case as described on page 6 of our letter.

Paragraphs 21-35

- These paragraphs (except for 29) are incorporated nearly verbatim from paragraphs 42-45 and 49-56 of AS 5. We recommend replacing these paragraphs in AS 5 with a reference to the appropriate guidance in this standard. Also we suggest that the PCAOB consider incorporating into paragraphs 21 and 23 of the proposed standard the guidance on smaller, less complex companies from the Notes to AS 5 paragraphs 42 and 44.

PRICEWATERHOUSECOOPERS

APPENDIX

Paragraph 37

- Paragraph 37 provides guidance about the factors the auditor should consider to determine the evidence needed in the current year audit to support the auditor's control risk assessment. The factors listed include those in paragraph 58 of AS 5; however, unlike paragraph 58, which incorporates the factors identified in paragraph 47 of AS 5 by reference, paragraph 37 includes some of the factors from paragraph 47 but seems to exclude other relevant risk factors from paragraph 47 (e.g., the nature and materiality of the misstatements that the control is intended to prevent or detect and the degree to which the control relies on the effectiveness of other controls). We recommend incorporating paragraphs 46 and 47 of AS 5 in this proposed standard under the subhead "Relationship of Risk to the Evidence to be Obtained," and then aligning paragraph 37 more closely with paragraph 58 in AS 5.

Paragraph 41

- We recommend that the last sentence of the Note to paragraph 41 be modified as follows:

  "Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the ~~effectiveness~~ control ***being tested***."

Paragraphs 47-50

- We suggest replacing the phrase "at interim dates" or "at an interim date" with the phrase "as of an interim date" in these paragraphs.

Appendix 5: *Evaluating Audit Results*

Paragraph 3(a)

- If the PCAOB retains the definition of error in paragraph 3(a), we recommend adding a footnote reference to footnote 3 in Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, which explains that the term "error," as used by the FASB, is equivalent to the definition of "misstatement" in the auditing literature.

Paragraph 3(b)

- The term "misstatement" is not defined. The proposed definition appears to instead be a definition of a "material misstatement." We recommend defining these terms separately and as follows:

  Misstatement - A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should have been reported in accordance with the applicable financial reporting framework. Misstatements can result from error or fraud.

  Material Misstatement - A misstatement that, individually or in combination with other misstatements, causes the financial statements not to be

PRICEWATERHOUSECOOPERS

APPENDIX

presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

Paragraph 4

- A requirement in paragraph 27 of ISA 330 that the auditor "should consider" all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements, has been changed to a requirement that the auditor "should evaluate" that evidence. We believe "should consider" provides appropriate direction. If not adopted, the PCAOB should clarify whether the auditor's response and level of documentation are expected to differ under the proposed standard.

Paragraph 13

- We believe that the proposed standard would be strengthened by incorporating the application guidance that has been omitted from paragraph A2 of ISA 450 which clarifies that "clearly trivial" is not another expression for "not material."

Paragraph 15

- We suggest modifying the phrase at the end of the sentence as follows: "…. when taken with the aggregate of misstatements accumulated during the audit ***that remain uncorrected***, …."

Paragraph 16

- We recommend strengthening paragraph 16 by incorporating the requirement in ISA 450 paragraph 8 that the auditor should request that management correct the misstatements communicated.

Paragraph 19

- This paragraph uses the words "detected in prior years" instead of "related to the prior year" as used in ISA 450, paragraph 11. We believe this changes the meaning since there may be misstatements detected in the current year and related to the prior year, which would be encompassed in the ISA language, but not the PCAOB language.

Paragraph 25

- The guidance requires that the auditor "should assess" the qualitative aspects of the company's accounting practices when evaluating whether the financial statements as a whole are free of material misstatement, whereas paragraph 12 of ISA 700 states that the auditor's evaluation "should include consideration" of the qualitative aspects of the entity's accounting practices. We believe "should consider" provides appropriate direction. If not adopted, the PCAOB should clarify whether the auditor's response and level of documentation are expected to differ under the proposed standard.

PRICEWATERHOUSECOOPERS

APPENDIX

Paragraphs 30 and 32

- We believe the requirement in paragraph 32 that the auditor's assessment of fraud risks should be ongoing throughout the audit would be more appropriately placed in Appendix 3, *Identifying and Assessing the Risks of Material Misstatement*, perhaps following paragraph 61, along with a footnote reference to paragraph 30 of this proposed standard. We also suggest replacing the phrase "earlier in the audit" in paragraph 30 with the phrase "throughout the audit." Finally, we recommend moving Appendix A, "Matters That Might Affect the Assessment of Fraud Risks," to Appendix 3.

Paragraphs 39-40

- The guidance in these paragraphs should be simplified to state that the auditor performing an integrated audit should determine how the results of tests of controls performed in the audit of internal control over financial reporting, including any identified control deficiencies, affect the appropriateness of risk assessments and the nature, timing, and extent of substantive procedures in the audit of the financial statements.

Paragraphs 41-44

- The guidance under the heading "Evaluating the Results of the Audit of Internal Control Over Financial Reporting" is not relevant to the auditor performing an audit only of financial statements. We therefore recommend replacing these paragraphs with a reference to the appropriate guidance in AS 5.

Appendix 6: *Consideration of Materiality in Planning and Performing an Audit*

Paragraph 6

- Paragraph 6 repeats a requirement from paragraph 20 of AS 5 that the auditor "shall use the same materiality considerations he or she uses in the audit of the company's annual financial statements." The placement of this paragraph in the subsection "Materiality for the Financial Statements as a Whole" could be interpreted to mean that it is not relevant, for example, in the subsection "Materiality for Particular Accounts or Disclosures." We recommend including this guidance in the Introduction in paragraph 1.

Paragraphs 8 and 9

- Paragraphs 8 and 9 require the auditor to determine the amount of “tolerable misstatement.” ISA 320, paragraph 12, uses the term “performance materiality” for essentially the same concept, as does the ASB's proposed auditing standard *Materiality in Planning and Performing an Audit*. Since these terms seem to have the same meaning, we recommend the PCAOB replace the term "tolerable misstatement" with "performance materiality" to avoid confusion.

Paragraph 9

- A requirement in existing PCAOB AU 312.23 that the auditor "should consider" the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods has been changed in this paragraph to a requirement

PRICEWATERHOUSECOOPERS

APPENDIX

that the auditor "should take into account" that information. We believe "should consider" provides appropriate direction. If not restored, the PCAOB should clarify whether the auditor's response and level of documentation are expected to change under the proposed standard.

Appendix 7: *Audit Evidence*

Overall

The proposed standard is silent on use of evidence from previous audits. ISA 500 application material (paragraphs A1, A11, and A26) acknowledges that information from previous audits may be included in audit evidence. The PCAOB should acknowledge that information obtained in previous audits may be used as possible audit evidence.

Paragraph 2

- We recommend that the PCAOB adopt a consistent approach to defining terms. We believe that the guidance in paragraph 2 is intended to be a definition and, as such, that it should be included in a Definitions section of the standard (consistent with the approach taken in Appendix 3 and Appendix 5).

Paragraph 3

- While we do not disagree with the objective stated in paragraph 3, it seems overly broad in the context of the guidance in the proposed standard. We recommend conforming to the ISA 500 objective, which focuses on designing and performing audit procedures in order to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

Paragraph 4

- Consistent with our comment on paragraph 3, the requirement in paragraph 4 should be replaced with that in paragraph 6 of ISA 500 to better focus on the auditor's requirement to design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

Paragraph 27

- We recommend that the PCAOB incorporate guidance in this paragraph acknowledging that “selective examination of specific items, particularly if those items are selected based on the auditor’s belief that they are more likely to contain a misstatement, may provide the auditor with some audit evidence concerning the remainder of the population” from paragraph A26 of the ASB's proposed auditing standard, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

Paragraph 29

- A requirement in paragraph 11 of ISA 500 that the auditor "should consider" the effect of inconsistent evidence on other aspects of the audit has been changed in this paragraph to a requirement that the auditor "should assess" the effect. We believe "should consider"

PRICEWATERHOUSECOOPERS

APPENDIX

provides appropriate direction. If not adopted, the PCAOB should clarify whether the auditor's response and level of documentation are expected to differ under the proposed standard.

Appendix 8: Proposed Conforming Amendments to PCAOB Standards

Overall

We recommend marking proposed conforming amendments from the text of extant standards to clarify how the proposed changes are intended to change audit practice and to improve the transparency of the Board's standard-setting process. This would be particularly helpful to commenters when the Board is proposing extensive changes to its interim standards as, for example, in the case of AU 316 *Consideration of Fraud in a Financial Statement Audit* and AU 350 *Audit Sampling*.

We agree with the Board's proposed replacement of "competent" with "appropriate" in describing audit evidence throughout the PCAOB standards. We also recommend that the term "evidential matter" be replaced with "audit evidence" throughout the PCAOB standards to be consistent with the Board's proposed risk assessment standard *Audit Evidence*.

AU sec. 350, "Audit Sampling"

Conforming change (n) to replace paragraph AU 350.23

- The PCAOB proposes to replace a requirement in the first sentence of extant AU 350.23 that the auditor "should consider" various factors in determining the number of items to be selected in a sample for a particular substantive tests of details with a requirement that the auditor "should take into account" these factors. We believe "should consider" provides appropriate direction. If not restored, the PCAOB should clarify whether the auditor's response and level of documentation are expected to change under the proposed standard.

- We believe the phrase "size and frequency of" preceding "misstatements" is unnecessarily prescriptive and we recommend deleting it.

- The role of professional judgment is critical in determining sample size when nonstatistical sampling is used. That should be acknowledged in this paragraph, consistent with existing PCAOB guidance and with the guidance in paragraph A11-A12 of ISA 530 (Redrafted) *Audit Sampling* and paragraph A15 of the ASB's proposed standard *Audit Sampling* (Redrafted). We observe that the PCAOB has not deleted numerous other references to professional judgment in extant AU 350.

- We recommend moving the last sentence of paragraph 23A, edited as proposed below in our comment on conforming changes (o) and (s), to become the last sentence of paragraph 23 because it is a natural extension of the guidance proposed in the bullet above.

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APPENDIX

Following are the changes recommended above marked from paragraph 23 as it is proposed to be changed by PCAOB conforming change (o):

> .23 To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should ***consider*** ~~take into account~~ the tolerable misstatement; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected ~~size and frequency of~~ misstatements. ***An auditor who applies nonstatistical sampling uses professional judgment to relate these factors in determining the appropriate sample size. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to the sample size resulting from an efficient and effectively designed statistical sample.***

Conforming change (p) to replace the last sentence of paragraph AU 350.25

- The PCAOB proposes to replace a requirement in the last sentence of AU 350.25 that the auditor "should consider" whether reasons for the auditor's inability to examine the items have other implications for the audit with a requirement that the auditor "should evaluate" such reasons. We believe "should consider" provides appropriate direction. If not restored, the PCAOB should clarify whether the auditor's response and level of documentation are expected to change under the proposed standard.

- We recommend the PCAOB restore guidance deleted from extant AU 350.25 by adding the phrase "and the planned assessed level of control risk" after the phrase "particularly the assessment of the risk of material misstatement due to fraud." We believe this guidance is useful to practitioners.

Conforming changes (o) and (s) to add language to paragraphs AU 350.23A and .38

- We believe the PCAOB's proposed language implies that auditors are required to calculate sample sizes using both statistical and non-statistical approaches, in all circumstances, in order to compare the sample sizes. We suggest that the PCAOB remove the phrase “or larger than” from the last sentence of the proposed guidance in both paragraph 23A and paragraph 38, and add footnote 5 to the AICPA’s AU 350.23, which states "This guidance does not suggest that the auditor using nonstatistical sampling compute a corresponding sample size using statistical theory" to clarify the intent.

- We also recommend adding language to the last sentence in paragraph 38 to acknowledge that nonstatistical sampling approaches will not result in sample sizes that are comparable to those determined by statistical sampling approaches applied to certain populations.

Following are the changes recommended above marked from paragraphs 23A and 38 as they are proposed to be changed by PCAOB conforming changes (o) and (s):

> .23A Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of

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APPENDIX

whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to~~, or larger than,~~ the sample size resulting from an efficient and effectively designed statistical sample. [x]

[x] ***This guidance does not suggest that the auditor using nonstatistical sampling compute a corresponding sample size using statistical theory.***

.38 To determine the number of items to be selected for a particular sample for a test of controls, the auditor should consider the tolerable rate of deviation from the controls being tested, the likely rate of deviations, and the allowable risk of assessing control risk too low. An auditor applies professional judgment to relate these factors in determining the appropriate sample size. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly ***to populations other than small populations and populations with infrequently operating controls***, the resulting sample size ordinarily will be comparable to~~, or larger than,~~ the sample size resulting from an efficient and effectively designed statistical sample.[xx]

[xx] ***See footnote x.***

From: Rod Scott -RGSA [mailto:rodscott@rgscottassoc.com]
Sent: Monday, February 16, 2009 3:46 PM
To: Comments
Subject: PCAOB Rulemaking Docket Matter No. 026

Sirs:

In reviewing your proposed standards related to the auditors' assessment of and response to risk, I found only eleven references to information systems and none of those were perscriptive as to the auditors actions related to Information Technology. This is particularly troubling since most auditors do not have in-depth backgrounds required to assess the risk associated with information technology. Risk assessment requires background and experience to perceive the risk. Guidance in the IT area is needed in "Identifying and Assessing Risk of material Misstatement" and in "Audit Evidence" proposals but is completely lacking. Therefore, this critical area will continue to be underestimated by the auditors.

Rod Scott
R.G. Scott & Associates, LLC
555 Ben Franklin Dr Unit 4
Sarasota, FL 34236

From: OGRV [mailto:rr@ogrv.com]
Sent: Friday, November 14, 2008 3:11 PM
To: Comments
Subject: Docket 26

Sirs or Madams

The proposed standards do not give an objective definition of material.
You could do make the standards better by giving materiality a real world definition.
Give us a formula that any fool could follow to arrive at amount acceptable to the PCAOB.

Such a formula or definition would save a lot of time and money.
It would bring the proposed rule into sharper focus.

It would prevent auditors from chasing windmills.

Roger Rotolante CPA
8000 SW 117 AVE –STE 206
Miami, Florida 33183

From: Saibeni, August [mailto:SaibenA@CRC.losrios.edu]
Sent: Wednesday, November 05, 2008 9:40 AM
To: Comments
Subject: Audit Risk in an Audit of Financial Statements PCAOB Rulemaking Docket Matter No. 026

Dear PCAOB,

I am writing this comment in response to the new proposed auditing standards, specifically, ***Audit Risk in an Audit of Financial Satements, PCAOB Rulemaking Docket Matter No. 026.***

Since audit risk is measured by the statistical factor of ***beta error or risk*** (the risk of inappropriately accepting a false statement) as opposed to ***alpha error or risk*** (the risk of inappropriately rejecting a true statement), I wonder if it could be helpful to express audit risk by incorporating beta error or risk into the definition of audit risk? For example, if we set audit risk at 5%, this is the beta factor we use for statistical sampling tests. The incorporation of beta in the definition of audit risk may help tie audit risk to statistical risk in a concrete way.

Sincerely,
August Saibeni, CPA, MS Bsn.
Adjunct Instructor
Cosumnes River College
Sacramento, CA

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

18 February 2009

Our ref: ICAEW Rep 18/09

Office of the Secretary
PCAOB
1666 K Street,
N.W.
Washington
D. C. 20006-2803.

cc. Arnold Schilder, Chair, IAASB

By email: *PCAOB Rulemaking Docket No. 026*

Dear Sir

PCAOB RELEASE NO 2008 - 006: PROPOSED AUDITING STANDARDS RELATED TO THE AUDITOR'S ASSESSMENT OF AND RESPONSE TO RISK AND CONFORMING AMENDMENTS TO PCAOB STANDARDS

The Institute of Chartered Accountants in England and Wales (the 'Institute') welcomes the opportunity to comment on the PCAOB's proposed auditing standards on risk assessment and consequential conforming amendments to the PCAOB's standards.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

Our comments have been prepared with the help of our many members working around the world who have detailed knowledge and practical experience of US, EU and other regulatory regimes. We have not sought to answer the PCAOB's specific questions but instead provide main and and detailed comments resulting from our discussions. We hope that this approach is of value to the PCAOB.

We strongly support the PCAOB's recognition of the importance of the IAASB's standards in the interests of the global convergence and the elimination of unnecessary differences between auditing standards in different jurisdictions. Nevertheless, there is a strong public interest case for the PCAOB to be transparent in its convergence efforts. Genuine convergence is achieved in practice by sacrifice and compromise on the part of all concerned in order to achieve a greater degree of consensus. We are concerned that the proposed standards amount to 'similarity, with add ons', which falls short of convergence and we therefore urge the PCAOB to explain clearly why the approach taken, is necessary or better than a more transparent 'ISA plus' strategy. This is particularly important if the IAASB is to be encouraged to improve its standards in areas where the PCAOB sees weakness.

Chartered Accountants' Hall
PO Box 433 Moorgate Place London EC2P 2BJ
www.icaew.com

T +44 (0)20 7920 8100
F +44 (0)20 7920 0547
DX DX 877 London/City

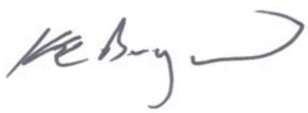
ICAEW THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

The UK adopted ISAs in 2005 and we hope that our knowledge thereof and experience in their implementation gives weight to our comments and observations below, although we have not yet performed a detailed analysis of the differences between the proposed standards and the IAASB's standards.

These standards, as the PCAOB notes, are the foundation for further standard-setting and it is important to get them right, and allow auditors sufficient time for proper implementation. A roundtable should be considered given the need for a degree of openness with these particularly important standards and re-exposure, if necessary, should be regarded as a strength rather than a weakness.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely



Katharine E Bagshaw FCA
Manager, Auditing Standards
ICAEW Audit and Assurance Faculty
T + 44 (0)20 7920 8708
F + 44 (0)20 7920 8754
E: kbagshaw@icaew.com

Chartered Accountants' Hall
PO Box 433 Moorgate Place London EC2P 2BJ
www.icaew.com

T +44 (0)20 7920 8100
F +44 (0)20 7920 0547
DX DX 877 London/City

Main Comments

Support for these proposed standards

We are pleased to note that the proposed standards reflect the Board's recognition of the importance of professional judgement, sound foundational principles for standard-setting and the elimination of unnecessary differences between auditing standards across jurisdictions. We are also encouraged by the positive approach to IAASB standards; starting with the IAASB standards was the right thing to do.

We supported the IAASB's clarity ISAs and have commented on each of them. We support further convergence and the proposed standards from the PCAOB are therefore welcome. The PCAOB had only just been established in 2004 when the IAASB revised the risk ISAs and it has made great progress since then. The convergence of accounting standards and the current demands for global solutions to the current market turmoil lead naturally to the convergence of auditing standards to facilitate consistency in the audit of financial statements. The only alternative is inefficient and cumbersome questionnaires covering differences in auditing standards and a box-ticking approach to auditing rather than the exercise of the sound professional judgement necessary for effective, high quality audits.

The UK's successful standard-setting model is clear about the basis for auditing standards; the full ISAs with a small number of 'pluses' addressing specific UK legal and regulatory requirements. The AICPA is converging its auditing standards with ISAs, as are standard-setters in other developed jurisdictions including Canada and many members of the EU. We encourage the PCAOB to consider the need for more systematic and transparent convergence with ISAs, not least because it would facilitate greater reliance upon other regulators in the PCAOB's inspection process. Standards that are properly converged to the maximum extent possible with ISAs enable international networks to have one core methodology supplemented in each member firm with local regulatory differences. This would have a positive impact on the inspection process as well as audit quality, and the costs of developing single audit methodologies, training programs and audit manuals.

The PCAOB's perspective on the differences between PCAOB and IAASB standards is valuable and illuminating. We note the active contribution made by the PCAOB's representative at IAASB meetings in an observer capacity. While the comparison between ISAs and PCAOB standards is helpful, we believe that a more comprehensive analysis of the differences between the two sets of standards from the PCAOB's perspective, setting out the criteria and rationale applied in deciding whether to adopt or reject a particular IAASB or other requirement or guidance, would be particularly helpful to standard-setters, other inspection bodies and auditors. Application guidance from the ISAs has in some cases been elevated to a requirement in the proposed standards and requirements from the ISAs have not. This is not simply an issue of inconsistent wording, but of inconsistent requirements in the two sets of standards. Convergence can only be achieved in a systematic and transparent manner.

These standards will have a major impact on audits but the process for assessing their impact is not clear. There is currently no cost benefit analysis. We encourage the PCAOB to perform a simple, high level impact assessment in the light of the issues associated with the implementation of AS 2. We do not believe that such assessments need to be lengthy or complex and we would be happy to provide an example of a qualitative assessment performed in the UK, in the context of UK corporate governance.

Drafting

Foundational principles

We note above our support for the idea of foundational principles on which to build further standards. The PCAOB is well aware of widespread international support for principles-based standards. It is also aware of the challenges in setting such standards where a principles-based regime is not necessarily well-understood or supported, and the importance of principles-based regulation and oversight to accompany principles-based standard-setting. However, the PCAOB is in a better position than many to overcome those challenges, as both inspector and standard-setter.

We therefore encourage the PCAOB to consider carefully the value of articulating the principles upon which the current proposed standards are, and future standards will be based. Such principles would need to articulate clearly criteria for the inclusion or exclusion of AICPA, IAASB and other material. We do not underestimate the amount of effort required to build consensus in this area but the PCAOB has a rare opportunity as a relatively 'new' standard-setter to develop a set of principles for auditing standard-setting without the 'burden' of an extensive corpus of extant standards.

Objectives

One of the most difficult hurdles the IAASB faced in drafting its clarified ISAs was in establishing a coherent set of objectives against which an auditor's performance could be evaluated. The importance of objectives that were not merely aspirations, or indistinguishable from the procedures and requirements of the standards themselves, nor mere repetitions of the titles of the standards, became apparent. The IAASB has in most cases dealt with these issues but there remain imperfect examples of objectives as a result of these problems. We note below some similar issues arising in the drafting of the PCAOB proposed standards and encourage the PCAOB to learn from the experience of the IAASB.

Terminology

We note an instance of the use of different terminology across jurisdictions for the same thing; footnote 22 to the additional discussion states that 'clearly trivial' means the same thing as 'clearly inconsequential'. This is just as much a problem for regulators internationally as the use of identical terms in different jurisdictions to mean different things. While it may seem burdensome to have to avoid the use of a word in its plain English context, simply because it is used in another jurisdiction with a specific technical meaning, there is a real risk that regulators operating in an international context will read the technical meaning into the use of the term in another jurisdiction where it is not intended. A good example of this was the practice of some regulators of inappropriately reading the technical meaning of the term 'material uncertainty' as used by the PCAOB into the same term used in other jurisdictions. This is sure to apply in reverse and in drafting standards the PCAOB should be aware of this risk, particularly in the context of the proposed standard on materiality, where terms already used by the IAASB are used to mean something different, without explanation.

Implementation date

An implementation date is not mentioned and it is likely that some time will be needed to implement these important standards. Forum of Firm members will be implementing clarity ISAs in 2010 and if the PCAOB intends implementation for 2010 audits it must signal that in 2009. It appears that the final standards are unlikely to be issued before summer 2009 and by the time they are approved by the SEC we believe that 2011 would be the earliest possible implementation date. Small firms auditing public companies in the US will need more implementation time.

Complexity of US GAAS for SEC registrants

US GAAS for SEC registrants will now be in three bodies of material; six extant PCAOB standards, the AICPA standards adopted by the PCAOB as its interim standards in 2003, and the proposed standards. The interaction of these standards is increasingly complex as the cross references and links become ever more convoluted and we see no proposed codification project in the immediate future. The lack of codification is confusing to auditors and will become even more confusing as the AICPA continues to change its own standards. Unnecessary complexity impairs auditors' ability to apply standards because it diverts attention to administration and away from the proper performance of audits.

Timescale

The development of high quality auditing standards cannot be rushed but nor need it be an excessively lengthy process. The IAASB's original time-span for the completion of the clarity project was six years (2005-11); the deadline was brought forward to 2008 and the project successfully completed in just three years without compromising the quality of ISAs. We urge the PCAOB to consider a systematic revision of standards to a published timetable. In this context, the timetable for the Concept Release due in 2009 on the review of interim standards appears on the face of it to be an overly lengthy process.

Substantive issues

Significant risks and fraud

There are requirements for substantive procedures for *all* significant risks, with little scope for the combination of work on controls and analytical procedures as required by ISAs; this may be onerous. Detailed substantive testing is not necessarily the appropriate response to *all* significant risks.

The introduction to the proposed standards makes much of the centrality of fraud but the ISAs have a great deal more on this in the application material. Application material is not only about the extent and effectiveness of work on fraud, but also about efficiency and ensuring that auditors do not do too much. For example, in the proposed standard *Identifying and Assessing Risks of Material Misstatement,* Appendix 3, paragraph 52(d) describes the procedures the auditor *should* perform in all circumstances related to specific inquires about fraud with accounting and financial reporting personnel, whereas ISA 240 paragraph A16 provides guidance that permits the auditor to use professional judgment in determining to whom in the entity it is most appropriate to direct fraud inquiries.

Detailed Comments

Audit Risk in an Audit of Financial Statements

1. Paragraph 10: the level of detection risk is reduced through the performance of tests of controls, as well as substantive procedures.

Audit Planning and Supervision

2. Paragraph 6: items (a) and (c) are largely practice management issues and to the extent that they are covered in ethics requirements, are caught by (b) in any case. Either (a) and (c) should be deleted, or, if there is a need to emphasise the ethical aspects of these issues, the paragraph might read

   ‘The auditor should evaluate whether the ethical aspects of client acceptance and engagement preliminaries have been properly addressed, including the following:

   - Acceptance or continuance of the client relationship
   - Compliance with independence requirements
   - Ensuring that the client understands the nature of the audit and other services to be performed’.

3. Paragraph 7: it is difficult to imagine how any of the matters listed would not be important to the audit provided that they are relevant and the words ‘*whether the following matters are important to the company’s financial statements and internal control over financial reporting and if so*’ could be deleted. It is arguable that this aspect of planning is in any case covered by risk assessment, that there is an overlap with paragraphs 8-19 of the standard on identifying and assessing risks, and that the material should be included there. This would be more in line with clarified ISA 300, *Planning an Audit of Financial Statements*.

4. Paragraphs 13 et seq: it would be helpful to deal with the issue of IT specialists in PCAOB standards in some other way than singling them out for particular attention in many different standards, particularly given that they now form a sub-category of an ever-widening range of ‘other’ professionals whose work is used by auditors.

Identifying and Assessing Risk of Material Misstatement

5. Paragraph 3: the word ‘*appropriately*’ is redundant and without it is a bare repetition of the title of the standard. Generally speaking, the auditor should be required to achieve a particular outcome in the interest of an objective. So the objective, as with the IAASB standard, might have words such as ‘*…and thereby provide a basis for designing and implementing responses to the assessed risk of material misstatement.*’

6. The word ‘*appropriately*’ appears again in paragraph 5 but is then abandoned in the first sentence of paragraph 56.

7. Paragraph 12: bullets 3 and 4 should be reversed – the latter will normally be more important than the former.

8. Paragraph 22: it is important to make a clear distinction between the evaluation of the design and implementation of controls in the context of obtaining an understanding (as here) and need to do so in the context of the response to assessed risks. The extensive forward cross-referencing here may give the impression that they are one and the same thing when in fact the former should require less depth than the latter.

9. Paragraph 26 refers to '*sound integrity and ethical values*'. Paragraph 48 refers to '*honesty and integrity*', paragraph 65 refers to '*honesty and ethical behaviour*' – all in the context of management. Furthermore, paragraph 23 of Evaluating Audit Results refers to the '*integrity*' of management. These need to be aligned. Honesty, integrity and ethical values are all evidenced by, and characteristic of, ethical behaviour, which is the all-encompassing category. There is no need to use two terms.

10. Paragraph 32: the last two bullets refer to the quarterly financial statements which should only be addressed to domestic issuers and not foreign private issuers in the context of the period-end reporting process.

11. Paragraph 34: gives no indication as to what control activities are.

12. Paragraph 52 (d): requiring auditors to solicit employee views on the aggressiveness (or otherwise) of the application of accounting policies decided on by management is a risky strategy; it smacks of snooping. It risks creating expectations that cannot be fulfilled, breeding distrust between management, auditors and employees and is likely to be unworkable.

13. Paragraph 55: more would be helpful on inconsistencies in responses and management fraud.

14. Paragraph 56 (b): '*and/or*' in the second line rather than '*and*' might be helpful.

15. Paragraph 56 (d): to permit auditors to take account of planned reliance on controls in assessing the magnitude of potential misstatement seems back to front.

16. Paragraph 56(e): this deals with identifying significant accounts or disclosures determined exclusively on the basis of inherent risk. Significant accounts and control risk surely come first?

17. Paragraph 63 (a): not all fraud risks are significant risks. It would be helpful to re-iterate here that fraud risks, as used in this context, are risks that could result in material misstatement, as per paragraph 28.

The Auditor's Responses to the Risks of Material Misstatement

18. No detailed comments

Evaluating Audit Results

19. Several of the requirements of this proposed standard seem to amount to either a requirement to re-audit certain areas or to perform procedures that are properly part of a firm's quality control processes. Paragraphs that could fall into either or both categories include paragraph 7,

20. Paragraph 15 (b): the phrase '*greater than an appropriately low level of risk*' in the first part of the note seems to be intended to mean the same as '*…this risk is unacceptably high…*' in the second part. If so, the same term should be used and if not, the difference explained. Anything that is greater than appropriately low must, by definition, be unacceptably high.

21. Paragraph 15 (b) Note: it is not clear what the additional procedures might be or what '*determine*' means. It is more likely that the auditor will tell the client to book the adjustment. Sometimes more work is not the answer.

Consideration of Materiality in Planning and Performing an Audit

22. Paragraph 5: the word '*surrounding*' is redundant.

23. Some of the explanatory material which currently appears in the Additional Discussion might usefully be incorporated into this standard, particularly given that the PCAOB has adopted terms other than those used by the IAASB. For example, the description of a reasonable investor on page A9-28 might help explain the term in paragraph 7, and '*material*' in paragraphs 8 and 10 might be supported by some of the explanatory material on pages A9-29.

Audit Evidence

24. The difference in the wording of the objective in paragraph 3 and the wording in paragraph 4 is unhelpful.

25. Paragraph 9: the requirement to modify or perform additional procedures in cases of suspect authenticity needs a link to professional skepticism, and further circumscription; many modifications are routine and to treat them as suspect may create inappropriate expectations.

The Institute of Internal Auditors

Richard F. Chambers
Certified Internal Auditor
Certification in Control Self-Assessment
Certified Government Auditing Professional

February 18, 2009

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803 USA

Response e-mailed to comments@pcaobus.org

RE: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk

Dear Sir/Madam:

The Institute of Internal Auditors (IIA) welcomes the opportunity to respond to the PCAOB's proposed auditing standards related to the auditor's assessment of and response to risk. Our comments are based on a thorough analysis and discussion, utilizing a core team of audit experts who serve on the Institute of Internal Auditors' Professional Issues Committee.

We commend the PCAOB for examining standards to:

- Determine where improvements could be made in view of improved risk-based audit methodologies;
- Serve as an improved foundation for future standard-setting;
- Enhance integration of the audit of financial statements with the audit of internal control over financial reporting; and
- Emphasize the auditor's responsibilities for considering the risk of fraud during the audit.

The following are our principal comments and observations. Detailed response to the questions posed in the exposure document, and other matters related to specific standards, can be found in Attachment A.

Overall, we believe that certain deficiencies in the old standards have not been fully addressed in these revisions. The draft PCAOB revisions could better address developments or other advances in audit methodology that have occurred in the past several decades.

As drafted, the auditing standards may not fully achieve the objective of improving the foundation for future standard-setting. Additionally, more clearly articulating the basic processes could encourage more high quality audits. Specifically:

1. Auditing Standard Number 5 provided appropriate guidance that audit procedures should be focused on areas where there is at least a reasonable risk of a material misstatement of the consolidated financial statements. We believe the same guidance should be clear and prominent in standards related to financial statement audits.

2. Risk assessment is the initial step in effective audit planning. Rather than the "finalized" plan directing the risk assessment, the risk assessment should be performed at the beginning of audit planning to shape the final audit plan.

Global Headquarters
247 Maitland Avenue
Altamonte Springs, FL
32701-4201 USA
T: +1-407-937-1100
F: +1-407-937-1101
www.theiia.org

Tel: +1-407-937-1200 • Fax: +1 407-937-1101 • E-mail: richard.chambers@theiia.org

3. We recommend standards on audit supervision be broken out from the standard on planning as they are two distinct topics. The discussion on supervision could better delineate the roles and responsibilities of the engagement partner versus other members of the audit team.

4. The discussion concerning the need for specialized skills or knowledge only discusses information technology skills; other specialized areas should be explicitly mentioned.

5. Consideration of the control environment is limited to it being a component of the system of Internal Control over Financial Reporting (ICFR). While the control environment is critical to ICFR, it is also critical to understanding the inherent risks of the company being audited. The control environment should be considered for all audits, not only for ICFR audit work.

6. There is a distinction between automated and manual processes. In practice business processes are often a combination of manual and automated activities. In addition, the discussion of automated activities implies the most formal type of automation and does not address the more common use of user-managed applications, including spreadsheets and databases.

The IIA welcomes the opportunity to discuss any and all of these recommendations with you. We offer our assistance to the PCAOB in the continued development of this guidance.

Best Regards,

Richard F. Chambers

Richard Chambers, CIA

About The Institute of Internal Auditors
The IIA is the global voice, acknowledged leader, principal educator, and recognized authority of the internal audit profession and maintains the *International Standards for the Professional Practice of Internal Auditing (Standards)*. These principles-based standards are recognized globally and are available in 29 languages. The IIA represents more than 150,000 members across the globe, and has 99 affiliates in 165 countries that serve members at the local level.

Attachment A
Institute of Internal Auditors (IIA)
Response to PCAOB - Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk

Questions from Appendix 9 of the proposed standards are in bold italics, with the IIA responses following.

Proposed Standard - Audit Risk in an Audit of Financial Statements

1. ***Does the proposed standard appropriately describe audit risk and its component risks?***

   A material misstatement is assessed for the consolidated financial statements taken as a whole. The proposed standard breaks the risk of material misstatement into two levels – the overall financial statement level and the assertion level. The discussion in paragraphs 6 and 7 seems to lose the focus on the financial statements as a whole and introduces consideration of the affect on individual assertions. While consideration of the impact on individual assertions is proper, tying this consideration back to the ultimate objective – the financial statements taken as a whole – is not sufficient. We recommend the wording more explicitly and directly state that consideration of this risk at the assertion level is only an intermediary step for assessing the impact on the financial statements as a whole.

   Paragraph 9 addresses detection risk. The last sentence in the paragraph does not fully differentiate between the design and operating effectiveness of audit procedures. An improvement may read: "Detection risk is a function of the effectiveness of the design of an audit procedure and the operating effectiveness of the execution of the procedure by the auditor".

   Paragraph 10 states: "The level of detection risk is reduced through the performance of substantive procedures." Detection risk can also be reduced through compliance testing of internal controls. The greater the confidence the auditor has in the adequacy of the system of internal control over financial reporting, the lower the auditor's detection risk.

Proposed Standard - Audit Planning and Supervision

2. ***Is it reasonable and appropriate to extend the Auditing Standard No. 5 requirement regarding consideration of matters important to the audit of internal control over financial reporting to audits of financial statements?***

   The factors considered in Auditing Standard No. 5 are critical in gaining a proper understanding of an entity subject to audit, either an audit of internal control over financial reporting or financial statements. The extension of the AS No. 5 requirements is appropriate.

3. ***Is the direction regarding multi-location engagements reasonable and appropriate?***

   Audit procedures should be limited and focused on the risk of material misstatement to the consolidated financial statements. The allocation of materiality, as suggested in the guidance, could result in procedures that are not necessary.

When assessing the risk of material misstatement to the consolidated financial statements that may exist at one or more individual locations, we recommend consideration be given to the following:

- Is there a reasonable risk of misstatement at an individual location that would be material to the consolidated financial statements?
- Is there a common cause of misstatement at one or more individual locations (e.g., the use of the same automated systems, or the exercise of controls by the same individuals) such that there is an aggregated reasonable risk of misstatement across multiple locations that would be material to the consolidated financial statements?

Please also refer to our answer for question 4.

4. ***Is more direction needed regarding multi-location engagements? If so, in what areas is additional direction needed?***

As the incidence of regional and global shared service centers increases, audits need to be able to manage risks and activities that are not aligned along entity or location but along process lines. Guidance is needed to audit companies which are organized in this manner.

5. ***Are the responsibilities of the engagement partner for planning and supervision appropriate and reasonable, and is the proposed direction clear?***

As mentioned below, the topic of may be better addressed as a separate standard with the responsibilities of each role in an audit provided appropriate attention. As currently written, the responsibility of the engagement partner versus other audit team members is not clear.

Other matters

Paragraph 4 indicates an audit plan should include planned risk assessment procedures. Paragraph 10a confirms the plan is to direct the risk assessment procedures. Following this procedure may result in failure to fully understand risk prior to completing an audit plan and can result in an improperly focused audit. Risk assessment procedures need to be performed prior to finalization of an audit plan. An audit plan must consider a full assessment of risk before being finalized.

The list of planning activities in paragraph 7, while not intending to be comprehensive, could be enhanced as follows:

- It is missing any mention of a category of critical factors for audit planning. There is no mention of entity-level factors of the entity such as the attitude of management towards financial reporting, the level of resources devoted to financial reporting, the competency and training of accounting personnel, etc.
- Limiting the concern over legal and regulatory matters to those of which the company is aware implies such matters of which the company is not aware cannot impact the company's financial reporting.
- The complexity of the company's accounting is as important as the complexity of the company's operations.

The statement: "determine the significant factors that affect the direction of the engagement team" in Paragraph 9b may be of more value if it included more specific information.

The title preceding paragraph 13 and the text of paragraph 13 appear to be intended to address situations where specialized skill or knowledge is needed to successfully complete an audit. However, paragraphs 14 and 15 only address IT skills. This is could imply that only IT skills are specialized enough to require additional assistance. The increasing complexity of accounting related to derivatives, uncertain tax positions, business combinations, etc. can create situations where specialized skill or knowledge is needed for these issues. For many companies, IT issues represent much less audit risk than these complex accounting areas. The brief general mention of generic specialized skills in paragraph 13 could be more extensive.

Paragraph 17 briefly mentions that planning activities may need to be expanded for initial audits. The level of risk an initial audit brings can be much higher than this brief mention implies. The discussion should be expanded appropriate for the level of risk.

This standard covers both planning and supervision. These are both critical, but separate topics in an audit. Planning is a distinct phase in an audit, but supervision takes place throughout all phases of an audit. For example, supervision occurs during planning, and execution, and reporting. We recommend supervision be addressed in a separate standard.

Proposed Standard - Identifying and Assessing Risks of Material Misstatement

6. ***Does the proposed standard clearly and adequately describe the auditor's responsibilities for performing risk assessment procedures?***

   As discussed earlier, the tasks of audit planning versus risk assessment are out of order, and could cause confusion. In addition, the guidance for assessing whether there is a reasonable level risk of material misstatement of the consolidated financial statements at one or more individual locations not sufficient.

7. ***Are the additional procedures in paragraph 13 that the auditor should consider performing when obtaining an understanding of the company and its environment reasonable and appropriate for audits of issuers? Should these procedures be specifically required for all audits, or is the responsibility to consider performing the procedures sufficient?***

   The requirement is reasonable and appropriate, but the handling of this requirement in the standard is not sufficient. This topic is addressed in paragraphs 25 through 27 which is a part of the section "Obtaining an Understanding of Internal Control Over Financial Reporting (ICFR)". While the control environment is critical in assessing ICFR, it is not limited to being a topic only applicable to ICFR. Control environment is a critical component of inherent risk in addition to control risk. The choice of placement of this topic minimizes its comprehensive impact on a company and the effects it has.

   Addressing the control environment should be required due to its pervasive impact on the risk of an audit. Specifically how this consideration is structured in an audit should be dependent on the specific audit situation.

8. ***Is the new requirement to assess certain matters related to the control environment component of internal control over financial reporting reasonable and appropriate? Is the difference between the required performance for an audit of internal control over financial reporting and an audit of financial statements only clear?***

See response to question 7.

9. ***Is the additional direction regarding the period-end reporting process reasonable and appropriate for audits of financial statements only?***

The consideration of period-end reporting process is in the section titled "Information System Relevant to Financial Reporting and Communication". See the discussion following question 11 for comments on this section.

10. ***Are the requirements and direction regarding the auditor's responsibilities for evaluating design and implementation of controls as part of obtaining an understanding of internal control over financial reporting sufficient and clear? If not, what additional direction is needed?***

Yes

11. ***Does the additional description of the key engagement team members provide a better understanding of the expected participants in the discussion?***

Yes

12. ***Does the discussion of significant risks in this standard provide sufficient direction to enable auditors to identify significant risks?***

Yes

13. ***Should the proposed standards include specific requirements and direction regarding documentation, e.g., summaries of the identified and assessed risks and the linkage to the auditor's responses?***

Auditing Standard No. 3 provides sufficient guidance for the auditor to use judgment in preparing documentation.

Other Matters

Paragraph 11 mentions selected external factors that should be considered during the risk assessment in an audit. A key external factor not included on this list is an understanding of the regional business practices in which the company does business. With the increased globalization of business activity, and the diversity of business practices (as evidenced in the significant increase in FCPA violations, as an example), this factor is as important as the other factors listed.

Paragraph 12 lists aspects of the nature of the company that should be considered. A key element of the nature of the company is information about how the company performs its key business processes (e.g., invoicing, manufacturing, pension management). Of interest are who performs the process, where it is done, and what basic process is followed.

The Period-end Financial Reporting Process section in paragraph 32 is under the broader heading of "Information System Relevant to Financial Reporting and Communication". The placement of this paragraph could be confusing as it discusses a number of procedures which would not normally be considered part of an information system.

Paragraph 48 requires the audit team to set aside any prior beliefs they have about the integrity of management when considering the risk of fraud. This is appropriate if those beliefs are based on the absence of prior issues with management integrity. However, if the audit team has knowledge of factual information which shows a lack of integrity or honesty by management, this should not be set aside during the discussions described in this paragraph.

Paragraph 52c outlines inquiries to be made of the internal audit function regarding fraud risk. In the following section d, point (4) directs an inquiry concerning whether an employee is aware of instances of management override of controls and the nature and circumstances of such overrides. This inquiry should be included in section c as an inquiry also of internal auditors.

Appendix A (page A3-25) discusses manual versus automated systems. This discussion has not been updated to address current IT environments. The discussion makes a stark contrast between manual and automated systems, while in practice this distinction is often more blurred. The increased use of user-managed applications based on spreadsheet and database software increases the presence of business processes which are a blend of manual and automated systems. As written, the discussion assumes all IT systems are in formalized mainframe type environments. The most significant risks can often come from the far less formal, but still IT dependent, user-managed applications built on simpler computer applications. Please refer to the *Guide to the Assessment of IT and Business Risk*, published by the Institute of Internal Auditors, for a more complete description of the range of IT risks to be considered and the integration of IT and manual processes.

Proposed Standard – The Auditor's Responses to the Risk of Material Misstatement

14. ***Does the proposed standard clearly describe the auditor's responsibilities regarding tests of controls in integrated audits and in audits of financial statements only?***

    Yes

15. ***Are the requirement and direction regarding tests of controls appropriately aligned with Auditing Standard No. 5?***

    Yes

16. ***Does the proposed standard clearly describe the auditor's responsibilities regarding substantive procedures?***

    Yes

Proposed Standard - Evaluating Audit Results

17. ***Does the proposed standard clearly describe the auditor's responsibilities regarding the evaluation of audit results?***

    Yes

18. ***Are the requirements and direction regarding the accumulating identified misstatements and evaluating uncorrected misstatements appropriate and adequate?***

School of Accountancy

200 Fogelman College Admin Bldg
Memphis, TN 38152-3120

Office: 901.678.4569
Fax: 901.678.2685

THE UNIVERSITY OF MEMPHIS

November 18, 2008

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

PCAOB Rulemaking Docket Matter No. 2008-026
Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards

Dear Members and Staff of the Public Company Accounting Oversight Board:

I appreciate the opportunity to comment on the proposed standards, "*Evaluating Audit Results*" and "*Consideration of Materiality in Planning and Performing an Audit*." In that regard, I believe the PCAOB is failing to act on an opportunity to improve the quality of financial reporting for public companies. While materiality is an important issue in every independent audit, the proposed standards offer no substantive change to aid either the auditor or the user in regard to the underlying precision of audited financial statements. Instead, the proposed statements merely perpetuate the lack of needed guidance inherent in standards and regulations previously published. Accordingly, I would like to propose a more specific decision rule as to whether uncorrected misstatements should be considered material, i.e., important enough to influence the decisions of financial statement users.

In general, the auditor makes choices regarding the precision of account balances at two different phases of an audit: (1) when considering the necessary precision of audit tests (referred to in the proposed standards as "tolerable misstatement" and (2) when deciding whether known and likely uncorrected misstatements should be recorded to prevent the financial statements from being misleading. While both decisions are important, for the remainder of my discussion I focus on a decision rule related to waiving or requiring recording of uncorrected misstatements.

Why Is A Specific Decision Rule Needed?

As with existing standards, under the proposed standards the concept of consistency likely will be violated. In a set of comparative financial statements for example, three years of Statements of Income are presented, each prepared with a level of materiality relative to that specific year. The differing levels of precision make horizontal analysis, i.e., comparisons over time, problematic as there is no consistency between the balances being compared. Such differences in precision either may hide or may overemphasize differences between periods. Similarly, as I demonstrate in a refereed journal article, "The Impact of Materiality Decisions on Financial Ratios—A Computer Simulation," immaterial misstatements can combine to adversely impact

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vertical analysis as well.[1] In a second refereed journal article, “Aligning Auditor Materiality Choice and the Needs of a Reasonable Person,” I also demonstrate that misstatements considered immaterial by the heuristics commonly used by auditors can have significant impacts on earnings per share.[2] As this clearly is an important metric used by investors, significant variations resulting from inconsistent auditor judgments are not helpful and do not meet the needs of financial statement users.

In addition to problems of consistency, neither current nor the proposed standards address continuing calls for increased transparency in financial reporting. Auditors do not publicly disclose decisions about materiality, thus there is no way for financial statement users to reliably analyze comparative or even single-year statements. It can be argued reasonably that lack of knowledge regarding financial statement precision is contrary to the need for transparency.

What Would Be a Useful Decision Rule?

It is clear that existing audit standards and regulations, accounting principles promulgated by the FASB, and findings by the courts all are consistent in requiring that the needs of reasonable financial statement users be the factor used to determine an appropriate level of materiality. It also is clear that auditors have a tremendous degree of flexibility in determining what an appropriate level should be. A substantial body of research, however, points to a serious disconnect between levels considered material by auditors and levels considered important by financial statement users. A study commissioned by the Big Five Audit Materiality Task Force, for example, finds “statistically significant price responses to earnings surprises of as little as 0.03 percent of assets and price, amounts far below conventional rules of thumb for materiality in accounting and auditing.”[3] Numerous other studies have reached similar conclusions.

To be consistent, a decision rule for determining reporting materiality levels should have certain characteristics. First, materiality should reflect a primary measure common to all financial statements and known to be important to users. Second, both producers and users of financial statements should understand the basis on which materiality is established. Third, for comparability the same basis should be used for all financial statements.

A logical solution is to define materiality based on the effect on earnings per share rather than as an absolute dollar magnitude as presently done. An earnings per-share metric satisfies all three characteristics identified above and reflects a measure known to be important to financial market responses. It is easily understood and provides a uniform measure across entities and industries.

Given substantial anecdotal and empirical evidence that one cent per share is viewed as important by the markets and to comply with the professional and legal definitions of materiality, the acceptable precision of financial statements should be established to be relative to that amount. This would require recording of every uncorrected misstatement that either would increase or decrease primary earnings per share by one cent or more and could be stated as:

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> "An uncorrected misstatement in a financial report is material if the magnitude of the item, either individually or in aggregate with other uncorrected misstatements, is such that, if corrected, the result would be a change in primary earnings per share of one cent or more."

Implementation of this new definition of materiality would provide financial statement users with greater confidence in the reliability of the financial statements as the issue of auditors allowing identified large omissions or likely misstatements to remain uncorrected should no longer be relevant. Additionally, if auditors adhere to this policy, questions about auditor independence should be greatly reduced.

Conclusion

With issuance of new standards, the PCAOB has the opportunity to make audited financial statements more reliable, more transparent, and more useful. To achieve this objective and to improve reporting transparency, however, financial statement reporting materiality needs a more precise definition. A substantial body of anecdotal evidence and rigorous research points to earnings per share as being one of the most valuable metrics for valuation and comparison available to financial statement users. I recommend that the proposed standards be revised to define an uncorrected misstatement as being material if correction of that misstatement would change earnings per share by one cent. This simple definition would result in a much greater degree of confidence in the reliability of audited financial statements.

I would be pleased to discuss my comments with members of the Public Company Accounting Oversight Board or its staff. If you have any questions or would like to discuss these issues, please feel free to contact me at 901-678-3507.

Very truly yours,

Jerry L. Turner

Jerry L. Turner, PhD, CPA (Inactive), CIA
Professor of Accountancy

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[1] Turner, J. 1997. The Impact of Materiality Decisions on Financial Ratios—A Computer Simulation. *Journal of Accounting, Auditing & Finance* 12(2): 125-147.
[2] Turner, J. 2007. Aligning Auditor Materiality Choice and the Needs of a Reasonable Person. *Journal of Forensic Accounting* VIII(2): 29-52.
[3] Kinney, W., D. Burgstahler and R. Martin. 2002. Earnings surprise "materiality" as measured by stock returns. *Journal of Accounting Research* 40(5): 1297-1330.

CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

RICHARD H. MURRAY
CHAIRMAN

1615 H STREET, NW
WASHINGTON, DC 20062-2000
(212) 317-5339
Richard_Murray@swissre.com

February 18, 2009

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 026

Dear Members and Staff of the Public Company Accounting Oversight Board:

The United States Chamber of Commerce ("Chamber") is the world's largest business federation representing more than 3 million businesses and organizations of every size, sector, and region. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy.

The CCMC recognizes the vital role of external audits in the sound operation of our capital markets and supports efforts to maintain and improve audit effectiveness. Auditors' assessment of and response to risk are fundamental to the audit process, and so we appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk*. Our comments focus on the following issues:

1. Convergence of auditing standards
2. Fraud
3. Materiality
4. Auditor judgment
5. Revision of Interim Standards

The CCMC strongly believes that these proposals are incomplete in their scope, do not reflect the circumstances presented by the ongoing financial crisis, and should be re-evaluated so as to properly achieve the objectives of the PCAOB. Accordingly, the CCMC recommends that the PCAOB withdraw these proposals, reevaluate, and reintroduce them at an appropriate time for public comment.

1. Convergence of Auditing Standards

The release text for the proposed standards notes that the International Auditing and Assurance Board ("IAASB") has updated its auditing standards regarding risk assessment. However, the release text does not mention that the Auditing Standards Board ("ASB") has done likewise. Further, the ASB and the IAASB have committed to converging their two sets of standards. Nevertheless, the PCAOB fails to take into account or promote the need for international convergence of auditing standards.

The CCMC, along with a number of other groups both domestic and international, support efforts to converge auditing standards. For example, the release from the G8 Summit of Business Leaders in Paris (December 3 and 4, 2008) *Ready for the Future*, in which the Chamber participated, includes the following recommendation:

> ***The appropriate national authorities need to launch an international convergence of standards for auditing of accounts***
> *While there has been the establishment and growing acceptance of a global accounting standard, this represents only one part of financial reporting policy. There is a similar need to ensure that a global standard for auditing of accounts in order to guarantee an appropriate level of scrutiny and thoroughness to ensure transparent high-quality information for investors and preparers alike. Such a system will also aid cross-border consultation and collaboration amongst appropriate regulators.*

The PCAOB fails to acknowledge the globalization of the economy and the unique needs these changes have imposed upon businesses and investors alike. Commonalities in the dissemination, reliability, and evaluation of financial information assist in the sound operation of markets. The PCAOB has missed the opportunity to advance the convergence of international auditing standards. While much focus and attention has been paid to the globalization of accounting standards, it is just as important for financial reporting policies to operate effectively, that a similar effort be undertaken for auditing standards. The Madoff and Satyam scandals clearly illustrate that failures in financial reporting have world-wide implications. From an audit standpoint, this means auditing standards that are global in scope. Although the PCAOB considered the IAASB standards in developing its own proposed standards, they have failed to make the case that public company audits in the U.S. are sufficiently unique, that they require their own auditing standards, or that the PCAOB's proposed standards, if they differ from the IAASB's in both form and content, are somehow better.

Accordingly, the CCMC urges the Board to do more than just consider the IAASB's standards. Rather, the CCMC would respectfully request that these proposals be withdrawn and recast with an eye towards international convergence of auditing standards. The PCAOB should work with all interested parties to start this process. Since this has been a stated goal since its inception; the CCMC stands by to work with the PCAOB to assist in this effort.

2. Fraud

In the proposed language on fraud, the PCAOB provides some discussion of the recommendations of the Public Oversight Board Panel on Audit Effectiveness (PAE). However, the PCAOB fails to mention that the current PCAOB Interim Auditing Standard, AU Section 316, *Consideration of Fraud in a Financial Statement Audit*, was promulgated, among other reasons, in response to the recommendations of the PAE to focus the auditor's attention on and improve the response to the risk of fraudulent financial reporting. While recognizing that materially misstated financial statements due to fraud are rare events, the PAE noted that auditors need to be alert that fraud can exist as to any client and must avoid complacency in the face of its rarity. AU Section 316 mandated new and specific requirements to address fraud risk.

The PCAOB exposure draft proposes several revisions in both the form and content of the existing fraud standard. While keeping most, but not all, of the requirements the same, it moves many of the requirements out of the fraud standard (AU Section 316) and folds them into other sections. This revision is justified in the release text under the rationale that the inspection process has identified instances where auditors performed the procedures mechanically or failed to respond appropriately to any identified fraud risk factors. Unfortunately, a change in form is unlikely to adequately address this concern from inspections and may, instead, have the opposite effect. A change in form will not cause any meaningful change in audit firm methodologies. If auditors currently view the consideration of fraud as an isolated, mechanical process rather than an integral part of the audit, they will likely continue to do so. It is the rarity of fraud that is the heart of the problem, not where the guidance is located in auditing standards.

Moreover, in a few instances, the proposed standards change the existing fraud guidance and, therefore, actually run the risk of undermining the very problem that the PAE sought (and the PCAOB seeks) to address. For example, the "brainstorming" requirement in AU Section 316 is specifically intended to highlight the need for auditors to recognize and address potential fraud risks on every engagement. The proposed standards revise this activity and turn it into "a discussion among engagement team members regarding risks of material misstatement" whether from error or fraud. While unintentional, by generalizing this discussion, the proposed standard will likely dilute the import of this discussion with respect to fraud.

In addition, the PCAOB has a number of other ways to address any concerns over mechanistic approaches to performing fraud-related audit requirements. For example, the Department of the Treasury Advisory Committee on the Auditing Profession (ACAP) urged the PCAOB to create "a national center to facilitate auditing firms' and other market participants' sharing of fraud prevention and detection experiences, practices, and data and innovation in fraud prevention and detection methodologies and technologies, and commission research and other fact-finding regarding fraud prevention and detection, and further the development of best practices regarding fraud prevention and detection." The CCMC strongly supports the ACAP's recommendation and encourages the PCAOB to begin the process of establishing the center.

One additional fraud-related concern the CCMC has is the proposed revisions dilute AU Section 316. Even though most existing requirements remain and are simply moved to other sections, given the importance that market participants place on auditors' responsibilities in the area of fraud, it is at least a tactical mistake to leave AU Section 316 so sparse. Investors, other financial statement users, and those less familiar with auditing standards would expect to locate auditors' responsibilities for fraud in the section devoted to that topic. Thus, the proposed standards may unnecessarily raise issues and create difficulties for the auditing profession and market participants alike.

3. Materiality

Section AU 312, *Audit Risk and Materiality in Conducting an Audit,* is also diluted through the deletion of guidance that is useful to auditors. The CCMC encourages the PCAOB to reconsider this decision and restore this guidance. In addition, the CCMC is disappointed that the PCAOB passed up the opportunity to improve guidance for auditors on materiality.

To illustrate our concerns, the CCMC encourages the PCAOB to restore the statement from AU Section 312.20: "The auditor plans the audit to obtain reasonable assurance of detecting misstatements that he or she believes could be large enough, individually or in the aggregate, to be *quantitatively* material to the financial statements." The CCMC believes the PCAOB should provide additional guidance on how auditors should map to quantitative materiality for the financial statements as a whole from statements in FASB Concept Statement No. 2 on the "total mix" of information. Furthermore, the first footnote in the proposed standard on *Consideration of Materiality in Planning and Performing an Audit* should caution that the Securities and Exchange Commission ("SEC") Staff Accounting Bulletin (initially known as SAB No. 99, codified as Topic 5M) provides guidance on qualitative materiality for evaluation purposes, not planning. The PCAOB should also provide additional guidance to auditors on tolerable misstatement. Allocating materiality for the purposes of assessing risks of material misstatement and planning and performing audit procedures is a task that is unique to auditors. It is a difficult assignment that requires judgment and the exposure draft provides no guidance to help auditors make these judgments. (And, AU 350.18, referenced in footnote 4, does not fill the breach.)

4. Auditor Judgment

Finally, while the CCMC recognizes the importance of judgment and supports audit standards based on judgment, we also believe that audit effectiveness would benefit from additional PCAOB guidance on auditor judgment. This view was previously expressed in the CCMC's letter to Chairman Mark Olson dated October 9, 2008. Our review of these proposed standards related to risk only reinforces this belief. In this regard, the CCMC notes that the final report of the SEC's Advisory Committee on Improvements to Financial Reporting ("CIFiR") Report recommended that the PCAOB "develop and articulate guidance related to how the PCAOB, including its inspections and enforcement divisions, would evaluate the reasonableness of judgments made based on PCAOB auditing standards." Further, "the PCAOB's statement of policy should acknowledge that the PCAOB would look to the SEC's statement of policy to the extent the PCAOB would be evaluating the appropriateness of accounting judgments as part of auditor's compliance with PCAOB auditing standards."[1]

The CCMC strongly supports the CIFiR recommendation. Moreover, given the over-arching nature of auditor judgments, the PCAOB should articulate and expose for public comment this policy statement before making substantial revisions in existing Interim Auditing Standards. Such a policy statement would provide a framework for the PCAOB to consider any necessary revisions to the Interim Standards and it would provide a context for others to consider and comment on any such proposed revisions.

5. Revision of Interim Standards

Finally, the CCMC notes that at the October 2008 PCAOB Standing Advisory Group meeting, the staff disclosed the PCAOB's intent to develop a concept release for public comment and feedback in early 2009 regarding the PCAOB's plans for addressing its review of the Interim Standards. The concept release is to include a schedule and procedures for the review. The CCMC strongly recommends that this concept release be exposed for public comment and finalized before the PCAOB and the staff begins the process of revising the current Interim Standards.

Conclusion

The globalization of the economy, the ongoing financial crisis, as well as the Madoff and Satyam scandals all point to the need to strengthen the auditing process. Such a goal is important for the continued viability of the audit profession, as well as the reliability of information used by participants to allocate capital efficiently in the

[1] Page 93, *The Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission,* August 1, 2008

marketplace. While we acknowledge the sincerity and dedication of the PCAOB in proposing the standards discussed herein, the CCMC believes that these proposals are lacking in the current environment and wanting in the advancement of the audits that underpin sound financial reporting. Accordingly, the CCMC respectfully submits that these proposal be withdrawn and reevaluated in order for more suitable standards to be proposed at the appropriate time.

Sincerely,

Richard Murray
Chairman,
U.S. Chamber of Commerce
Center for Capital Markets Competitiveness

GAO
Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

February 18, 2009

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Subject: PCAOB Release No. 2008-006*, Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) proposed new auditing standards on assessing and responding to risk during an audit.

We appreciate the PCAOB's efforts to update its auditing standards on assessing and responding to audit risk for registered companies and agree that this process is a critical element of an effective audit. However, we continue to have serious concerns about the PCAOB's approach to updating its interim standards and believe it will increase the likelihood of misinterpretations, inconsistent application of the standards, and higher costs for all users with a disproportionate burden on smaller and mid-sized firms.

Currently PCAOB standards consist of (1) certain pre-existing standards developed by Auditing Standards Board (ASB) of the American Institute of CPAs (AICPA) as of April 16, 2003, which the PCAOB adopted as interim standards on an initial, transitional basis, and (2) standards developed by the PCAOB to satisfy requirements of Section 103 of the Sarbanes-Oxley Act of 2002 (the Act). Now the PCAOB proposes adding a new layer of standards by revising or supplementing certain core interim standards with new standards developed by the PCAOB, resulting in duplication of and inconsistencies between its standards and those of other established independent auditing standard-setting organizations. These new PCAOB standards include, in some cases, modified versions of other established standards without providing clear explanations of the reasons for or meaning of those differences.

For example, the PCAOB has adapted and included in its proposed standards only selected provisions of the International Auditing and Assurance Standards Board's (IAASB) audit risk standard and omitted much of the useful guidance. The differences between these two sets of standards are difficult to detect and understand because the PCAOB does not identify or offer a clear explanation of (1) the changes and omitted provisions, (2) why the changes and omissions are necessary, and (3) the implications for users. Unlike the corresponding International Standards on Auditing (ISA), which include discreet application and other material sections, the PCAOB standards combine requirements with application and other material, making it more difficult to identify the

ISA guidance that is not included in the PCAOB proposed standards. In addition, many of the PCAOB changes appear to be simple word choice preferences, but it is unclear whether the PCAOB is proposing more substantial changes. These inconsistencies in core standards are likely to increase audit costs and lead to confusion and misapplication of the standards.

Our second concern is that these proposed standards will needlessly create another version of standards related to important core auditing procedures and cause users to incur increased costs related to understanding and implementing two or more sets of standards. Users likely will incur increased staff training costs and may need to revise their auditing methodologies and develop crosswalks to identify differences between PCAOB standards and other base standards. Keeping up with multiple versions of standards and guidance from numerous sources is expensive for all firms and will have a disproportionate impact on small and mid-sized firms, as firms need to revise guidance for their staff or purchase prepared guidance material from external sources when new standards are issued.

Rather than revising or supplementing its standards with new standards developed by the PCAOB, we suggest using a more comprehensive, systematic approach of:

- adopting a base set of relevant existing and <u>prospective</u> standards of another established independent auditing standard-setting organization,
- developing any additional, incremental standards and requirements as necessary and appropriate for audits of U.S. registered companies and clearly explaining the nature of and reasons for the additional standards, and
- assuring that the entire set of PCAOB standards are widely available in an easy to use format.

The PCAOB could adopt as a base the standards of the IAASB, which is a standard-setting body designated by, and operating independently under the auspices of, the International Federation of Accountants (IFAC). An alternative is to adopt the standards of the ASB, which is the standard-setting body of the AICPA.

While PCAOB standards are used mostly for audits of U.S. publicly traded companies, more than 100 countries now use or are in the process of adopting or incorporating ISAs issued by the IAASB into their national auditing standards or are using them as a basis for preparing national auditing standards. ISAs have been translated into many different languages and are intended for use in audits of all types of entities, including publicly traded companies, private entities, not-for-profit organizations of all sizes, and government entities at all levels. These standards are subject to due process that is overseen by the independent Public Interest Oversight Board. In the U.S., the ASB standards are applied to financial audits of U.S. entities other than publicly traded companies. The ASB is in the process of converging its standards with those of the IAASB while trying to avoid unnecessary conflict with PCAOB standards.

As we've stated in previous comment letters, we strongly believe auditing standard setters should work together to achieve core auditing standards that are universally accepted. Where there is a clear and compelling reason, the individual standard-setting bodies should develop additional, incremental standards and requirements necessary to meet the needs of their respective constituencies. The nature of any differences from core auditing standards and the basis for the differences also should be clearly communicated.

For instance, GAO's *Government Auditing Standards* incorporates the ASB field work and reporting standards and supplements them with additional standards to satisfy the unique accountability needs of government entities. The SEC recognizes the financial accounting and reporting standards issued by the FASB, relying on the private sector for this function to the extent that the private sector demonstrates the ability to fulfill this responsibility in the public interest.

The climate surrounding auditing standards has dramatically changed since the PCAOB decided to adopt interim standards and supplement them with new PCAOB-developed standards. The IAASB has strengthened its due-process procedures, and its auditing standards are globally accepted and translated into dozens of languages. The PCAOB has issued or proposed standards addressing all specific rule requirements mandated in Section 103 of the Act. The PCAOB should consider adopting a rule that allows for adoption of a base set of standards on an existing and prospective basis unless action is taken to specifically exclude or modify them. This approach appears acceptable under the existing authority in section 103 of the Act and could lower the cost and burden on the PCAOB and on users of its standards.

The concerns we have noted above about the PCAOB's approach to setting standards are consistent with the views we previously expressed through the following means:

1. previous comment letters to the PCAOB dated May 12, 2008, May 18, 2007, and February 26, 2007;
2. our comment letter to the U.S. Securities and Exchange Commission (SEC) dated July 12, 2007; and
3. remarks at the April 4, 2007, SEC Open Meeting on Proposed Management Guidance for Section 404 of the Sarbanes-Oxley Act and the PCAOB's Proposed Revisions to Auditing Standard No. 2.

Similar concerns about the PCAOB's standard-setting approach also were raised by several attendees at the October 22-23, 2008, PCAOB Standing Advisory Group meeting. The standards that the PCAOB now proposes heighten rather than resolve these concerns.

PCAOB's Requested Comments

In the introduction to the release that accompanies the proposed auditing standards, the PCAOB has requested comments on specific aspects of the proposed standards. Our comments on these matters are noted below.

The Board seeks comment on how the proposed standards would change current practice, whether the proposed standards allow sufficient flexibility, and whether they are appropriately scalable. [page 6 of PCAOB Release 2008-006]

Studying and implementing the PCAOB standards will likely increase user costs and create a disproportionate burden for smaller and mid-sized firms, who may need to revise their auditing methodologies and develop crosswalks to identify differences between IAASB and PCAOB standards.

The Board seeks comment on whether these fundamental principles [i.e., the fundamental aspects of the audit process] are articulated appropriately in the proposed standards. [page 7 of PCAOB Release 2008-006]

We believe that the fundamental principles of the audit process are not appropriately addressed in the proposed PCAOB standards. The ED does not include the essential guidance in the ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with the ISAs*, which is critical to understanding what an audit is and underlies the risk assessment standards.

The Board seeks comment on whether these fundamental principles [re: integrated audits] from Auditing Standard No. 5 have been incorporated appropriately in the proposed standards, whether the proposed standards are appropriately aligned with Auditing Standard No. 5, and, accordingly, whether the proposed standards would improve the effectiveness and efficiency of integrated audits. [page 7 of PCAOB Release 2008-006]

We appreciate and understand the reasons for including Auditing Standard No. 5 considerations in the proposed standards, but we believe that the fundamental principles related to an integrated audit could be incorporated in the proposed standards more efficiently by issuing supplemental standards to address audit risk issues related to integrated audits of publicly traded companies. Such supplemental standards would accompany a common, core set of standards, such as the ISAs or the ASB standards.

The Board seeks comment on whether the proposed standards focus appropriately on the risk of fraud. [page 8 of PCAOB Release 2008-006]

As noted above, the PCAOB's current approach to including fraud considerations in the proposed standards creates another version of the standards for practitioners to learn and implement, and likely will lead to misinterpretations and inconsistent application of the proposed standards. More importantly, we believe that maintaining a discrete fraud standard rather than incorporating fraud considerations throughout other standards heightens the auditor's focus on this important topic.

The Board seeks comment on whether the proposed standards appropriately consider the provisions of the ISAs and whether they reflect necessary differences

from risk assessment standards applicable outside the United States. [page 9 of PCAOB Release 2008-006]

The proposed standards do not appropriately consider the provisions of the ISAs. Instead, they differ significantly from the IAASB audit risk standards without a clear explanation of what those differences are, why they are necessary, and the implications for users. In addition, as noted above, the ED does not include the fundamental guidance in ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with the ISAs*. These differences likely will increase costs for all firms and will have a disproportionate impact on small and medium-sized audit entities.

The Board requests comment on all aspects of the proposed standards and the conforming amendments to PCAOB interim standards, including, in particular, responses to the questions in Appendix 9. [page 11 of PCAOB Release 2008-006]

Because we believe that the public interest would be better served if the PCAOB adopted a base set of auditing standards, supplemented as necessary to address unique aspects of audits of publicly traded companies, we have not addressed the detailed questions posed in Appendix 9 of the ED.

We thank you for considering our comments on this very important issue.

Sincerely yours,

Jeanette M Franzel

Jeanette M. Franzel
Managing Director
Financial Management and Assurance

Enclosures

cc:

The Honorable Mary L. Schapiro, Chairman
Securities and Exchange Commission

The Honorable Mark W. Olson, Chairman
Public Company Accounting Oversight Board

Mr. Harold Monk, Jr., Chair
Auditing Standards Board

From: Graham Ward [mailto:graham@ward.us]
Sent: Wednesday, February 18, 2009 3:06 PM
To: Comments
Cc: Graham Ward
Subject: PCAOB Docket 26: Comment

Rulemaking Docket 026: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk; Proposed Conforming Amendments to PCAOB Standards
Comment: Graham Ward, Atlanta, Georgia. February 18, 2009.

As someone who began an auditing and risk management career some 25 years ago, I have observed and participated in many changes in financial and information technology audit. The current proposed standards are an excellent step in the ongoing evolution of audit and risk, and the PCAOB has performed a sterling job in pulling together and further developing the many existing risk statements and guidelines. Furthermore, the intent that the proposed standards, inter alia, “serve as an improved foundation for future standard setting” is clearly very worthwhile — one inevitability is that audit approaches and methodologies will continue to evolve and adapt, and the new standards need to cater for such changes.

However, one area where the proposed standards seem to be more retrospective than prospective is regarding the use of technology to mitigate risk and to perform substantive procedures. The proposed standards do mention, in two sections (A-4-6, para. 12c & A-5-15, para A1.c) the use of ‘computer-assisted audit techniques’ (itself a 25-year old term), but these mentions are trivial. Likewise, although the standards discuss consideration of risk factors such as the complexity and distribution of information technology, there is no mention of the potential use of technology by management to provide continuous monitoring of controls and transactions.

Firstly, the use of specialized analytics to inspect 100% of a data set should surely be an expectation of today’s public company audit, rather than a briefly-mentioned consideration. Analytical packages, such as ACL and IDEA (and Excel 2007), allow sophisticated review of large data volumes — today’s auditor should be using these tools as a matter of course. Although it is recognized that substantive tests cannot support a conclusion regarding the effectiveness of a financial control, such tests can undoubtedly identify failures of internal controls. The use of these data analytics should surely be advocated more forcibly by the new standards.

Secondly, the last few years have seen dramatic advances in the capabilities of continuous monitoring applications and their use by management. Configuration monitoring and segregation of duties tools, such as Approva, are now used by many large companies. Governance, Risk & Compliance applications are also used by many organizations to oversee and manage both the operation and testing of internal controls. Advanced continuous transaction monitoring software and services, provided by companies such as Oversight Systems, can be used to not only assess the reliability of financial transactions, master data, and associated controls, but can also be used to improve key processes and profitability (and can reduce audit costs). Although some of these technologies are relatively new, their use is increasing rapidly and they will undoubtedly be a key factor in the audit of the future. At the least I would expect the new standards to mention that the use of such software and processes should be considered by auditors in their assessment of risk; better still, the standards should discuss these technologies in some detail.

Lastly, seven auditing standards are proposed. Given the related subject matter of each standard, consideration should be given to combining the standards into two or three, rather than seven.

Graham Ward ■ 404-819-6492 ■ graham@ward.us

1666 K Street, NW
Washington, D.C. 20006
Telephone: (202) 207-9100
Facsimile: (202)862-8430

PROPOSED AUDITING STANDARDS RELATED TO THE AUDITOR'S ASSESSMENT OF AND RESPONSE TO RISK AND RELATED AMENDMENTS TO PCAOB STANDARDS	PCAOB Release No. 2009-007 December 17, 2009 PCAOB Rulemaking Docket Matter No. 026

Summary: The Public Company Accounting Oversight Board (the "Board" or "PCAOB") is reproposing seven auditing standards related to the auditor's assessment of and response to risk. The text of the proposed auditing standards and the related amendments (Appendices 1-8) will be applicable to all registered firms conducting audits in accordance with PCAOB standards and would supersede six of the Board's interim auditing standards.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 026 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on March 2, 2010.

Board Contacts: Keith Wilson, Associate Chief Auditor (202/207-9134; wilsonk@pcaobus.org), Hasnat Ahmad, Assistant Chief Auditor (202/207-9349, ahmadh@pcaobus.org), Diane Jules, Assistant Chief Auditor (202/ 207-9111, julesd@pcaobus.org), Jessica Watts, Assistant Chief Auditor (202/207- 9376, wattsj@pcaobus.org), and Hong Zhao, Assistant Chief Auditor (202/207- 9355, zhaoh@pcaobus.org).

RELEASE

1. Introduction

The Board is reproposing seven auditing standards ("new proposed standards") that collectively would replace the requirements for assessing and responding to risk during an audit. The existing PCAOB standards regarding risk assessment were developed, for the most part, during the 1980s. The new proposed standards have been informed by a number of factors and developments since that time. These include the risk-based audit methodologies currently used in many audits of issuers; recommendations to the profession on ways in which auditors could improve risk assessment;[1/] advice from the Board's Standing Advisory Group ("SAG");[2/] the adoption of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*; and observations from the Board's oversight activities. The provisions in the new proposed standards build upon and attempt to improve the framework established by existing PCAOB standards, rather than replace that framework altogether. Accordingly, while the Board is proposing to supersede several of its interim standards, the concepts underpinning the new proposed standards should be familiar to most auditors.

At the most basic level, the new proposed standards are, like existing PCAOB standards, rooted in the concept of audit risk. In an audit of financial statements, audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. In an audit of financial statements, the auditor's responsibility is to plan and perform the audit to limit audit risk to an appropriately low level, so the auditor can opine with reasonable assurance that the financial statements present fairly, in all material respects, a company's financial

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[1/] See, e.g., Public Oversight Board, Panel on Audit Effectiveness ("PAE"), *Report and Recommendations* (August 31, 2000). For a summary of the PAE's recommendations related to risk assessment, see PCAOB Standing Advisory Group Meeting Briefing Paper, "Risk Assessment in Financial Statement Audits" (February 16, 2005), Appendix A, available at http://www.pcaobus.org/News_and_Events/Events/2005/02-16.aspx.

[2/] Webcasts of those meetings are available on the Board's website at www.pcaobus.org/News_and_Events/Webcasts.

RELEASE

position, results of operations, and cash flows in conformity with the applicable financial reporting framework.[3/]

On October 21, 2008, the Board proposed seven auditing standards to update the requirements for assessing and responding to risk during an audit ("the original proposed standards").[4/] The original proposed standards were intended to improve the standards for audits of issuers by –

- Enhancing the effectiveness of auditors' assessment of and response to risk, especially in risk-based audits;
- Enhancing integration of the audit of financial statements with the audit of internal control over financial reporting;[5/]
- Emphasizing the auditor's responsibility for considering the risk of fraud during the audit; and
- Setting an improved foundation for future standard setting.

The original proposed standards also sought to eliminate unnecessary differences between the Board's risk assessment standards and the risk assessment standards of the International Auditing and Assurance Standards Board ("IAASB").[6/]

[3/] Paragraph .01 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles,* indicates that the auditor should look to the requirements of the Securities and Exchange Commission ("SEC") for the company under audit with respect to the accounting principles applicable to that company. The proposed standards use the term "applicable financial reporting framework" to describe the applicable accounting principles.

[4/] PCAOB Release No. 2008-006, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (October 21, 2008).

[5/] Other than certain related proposed amendments discussed in this release, the Board is not proposing changes to Auditing Standard No. 5, which was adopted in 2007 after notice and comment and approved by the SEC.

[6/] After the Board released its original proposal, the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA")

RELEASE

The Board received 33 comment letters on the original proposed standards.[7/] Many commenters were supportive of the Board's efforts to update its risk assessment requirements in light of risk-based audit methodologies, to align the fundamental principles from Auditing Standard No. 5 and to eliminate unnecessary differences from the risk assessment standards of the IAASB. A number of commenters expressed support for the Board's emphasis in the original proposed standards on the auditor's responsibilities for considering the risk of fraud. The commenters offered numerous suggestions for changing the original proposed standards, as well as comments about the Board's standards in general and its standards-setting process.[8/]

After considering all of the comments received on the original proposed standards, the Board has made numerous refinements to the original proposed standards. While evaluating the comments, the Board also identified other opportunities for improvements, which has resulted in further enhancement of the original proposed standards. Because these proposed standards address many fundamental aspects of the audit process and are expected to serve as a foundation for future standards setting, the Board is reproposing the standards for public comment. Subsequent sections of this release discuss areas of emphasis in the new proposed standards and provide an overview of each of the new proposed standards. Appendix 9 discusses changes to existing PCAOB standards resulting from the new proposed standards, responses to comments received on the original proposed standards, and differences between the original proposed standards and the new proposed standards.

2. Areas of Emphasis in the New Proposed Standards

This section discusses aspects of the new proposed standards that received particular attention. Appendix 9 discusses specific changes to the new proposed standards in these areas.

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issued a proposed update of its risk assessment standards as part of its clarity project. Appendix 10 compares the new proposed standards to the proposed ASB standards.

[7/] Comments on the proposal are available on the Board's website at http://www.pcaobus.org/Rules/Docket_026/index.aspx.

[8/] The Board continuously endeavors to improve its processes, including its standards-setting process, and is considering these comments as it does so.

RELEASE

A. Alignment with Auditing Standard No. 5

In the release accompanying the original proposed standards, the Board stated its belief that improvements in the requirements related to risk assessment should enhance integration of the audit of the financial statements with the audit of internal control over financial reporting. Because the original proposed standards described requirements for assessing risk, responding to risk, and evaluating audit results that apply to all audits, including integrated audits of financial statements and internal control over financial reporting ("integrated audits"), those proposed standards reflected certain foundational risk assessment principles that are also discussed in Auditing Standard No. 5.

Commenters generally supported this approach and suggested ways to enhance the alignment between the proposed standards and Auditing Standard No. 5. The new proposed standards include additional provisions from Auditing Standard No. 5 related to identifying and assessing risks that apply to financial statement audits. Certain provisions in the original proposed standards have been omitted from the new proposed standards because the provisions relate only to audits of internal control over financial reporting ("audits of internal control").

B. Consideration of Fraud

Like the original proposed standards, the new proposed standards continue to emphasize the auditor's responsibilities for consideration of fraud by incorporating the requirements for identifying and responding to risk of material misstatement due to fraud ("fraud risks") and evaluating audit results from the existing PCAOB standard, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*[9/] Incorporating these requirements makes clear that the auditor's responsibilities for identifying, assessing, and responding to the risks of material misstatement due to fraud are an integral part of the audit process rather than a separate, parallel process.

The Board has observed from its oversight activities instances in which auditors have performed the procedures required in AU sec. 316 mechanically, without using the

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[9/] Like the original proposed standards, the new proposed standards incorporate paragraphs .14 -.51 and paragraphs .68-.78 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. Accordingly, those paragraphs would be removed from AU sec. 316 by means of a related amendment. See Appendix 8.

procedures to develop insights on fraud risks or modify the audit plan to address those risks, and instances in which firms have failed to respond appropriately to identified fraud risks. These kinds of deficiencies suggest that some auditors may view the consideration of fraud as an isolated, mechanical process rather than an integral part of audits under PCAOB standards. The approach to integrate relevant requirements from AU sec. 316 would emphasize to auditors that assessing and responding to fraud risks is an integral part of an audit under PCAOB standards, rather than a separate consideration. It is also intended to prompt auditors to make a more thoughtful and thorough assessment of risks affecting the financial statements, including fraud risks, and to develop appropriate audit responses. However, AU sec. 316, with proposed amendments, will continue to provide relevant information on determining the necessary procedures for considering fraud in a financial statement audit.

The new proposed standards contain enhancements to the requirements for consideration of fraud in an audit based on comments received on the original proposed standards and other considerations. Such enhancements include revisions to the requirements regarding consideration of potential bias in financial statements and additional requirements regarding consideration of potential fraud risks related to omitting or presenting incomplete disclosures.

C. Auditing Disclosures

Disclosures have long been an important component of the financial statements, and PCAOB standards recognize that the concept of "present fairly in conformity with general accepted accounting principles" encompasses the principle that "the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation."[10/] However, many of the provisions regarding disclosures in existing PCAOB standards are limited to discussion of the effects of omitted disclosures on the auditor's report and the evaluation of specific disclosures, e.g., disclosures regarding the company's ability to continue as a going concern.

Based on observations from the Board's oversight activities, the Board believes that enhancing the requirements for evaluating disclosures can prompt auditors to be more thoughtful and thorough in their approach to testing and evaluating disclosures. The new proposed standards contain new requirements and discussion regarding the

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10/ AU sec. 411.04.

auditor's responsibilities for evaluating disclosures, which, collectively, would supersede AU sec. 431, *Adequacy of Disclosure in Financial Statements.*

3. Overview of the New Proposed Standards

Like the original proposed standards, the new proposed standards are intended to strengthen the requirements for assessing and responding to risk in an audit to enhance the auditor's focus on the areas of greatest risk. Accordingly, the new proposed standards would improve the requirements for performing procedures to identify and appropriately assess risks of material misstatement due to error or fraud, require appropriate responses to those risks, and enhance the requirements for evaluating the results of the audit. Also, like the original proposed standards, the new proposed standards would apply to all audits performed in accordance with PCAOB standards.

The new proposed standards, which are included in Appendices 1-7 of this release, are as follows:

- Audit Risk[11/]
- Audit Planning and Supervision
- Consideration of Materiality in Planning and Performing an Audit
- Identifying and Assessing Risks of Material Misstatement
- The Auditor's Responses to the Risks of Material Misstatement
- Evaluating Audit Results
- Audit Evidence

The new proposed standards will supersede six interim auditing standards: AU sec. 311, *Planning and Supervision,* AU sec. 312, *Audit Risk and Materiality in*

[11/] The original proposed standard was titled *Audit Risk in an Audit of Financial Statements.* The title of the new proposed standard was changed to emphasize the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit and audit of financial statements only.

RELEASE

Conducting an Audit, AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date,* AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit,* AU sec. 326, *Evidential Matter,* and AU sec. 431.

In addition to the new proposed standards, the Board is proposing certain related amendments to existing PCAOB standards, which are presented in Appendix 8.

A. Proposed Auditing Standard – Audit Risk

This new proposed standard discusses the components of audit risk in an audit of financial statements and the auditor's consideration of audit risk. These matters are fundamental to PCAOB auditing standards, including the other new proposed standards.

Also, the new proposed standard contains certain revisions and enhancements based on comments received on the original proposed standard and observations from the Board's oversight activities. The original proposed standard has been revised to relate more clearly the concept of audit risk to the opinion on the fair presentation of the financial statements, as expressed in the auditor's report. The new proposed standard also has been enhanced by expanding the discussion of risks of material misstatement at the financial statement level and by clarifying the relationship between detection risk and the performance of substantive procedures.

B. Proposed Auditing Standard – Audit Planning and Supervision

This new proposed standard describes the auditor's responsibilities for planning the audit, including assessing matters that are important to the audit and establishing an appropriate audit strategy and audit plan. The new proposed standard would apply to audits of financial statements only and to integrated audits. It would supersede AU sec. 311.

In developing this new proposed standard, the Board seeks to enhance the requirements for planning and supervision by:

- Explicitly articulating the engagement partner's responsibilities for audit planning and supervision;
- Requiring the auditor to develop an appropriate audit strategy and audit plan based on those matters that are important to the company's financial statements and internal control over financial reporting;

- Having the auditor focus more on the respective risks when planning multi-location engagements;

- Expanding the requirements for using persons with specialized knowledge and skills in areas in addition to information technology; and

- Tailoring the level of supervision of engagement team members based on, among other things, the risks of material misstatement.

C. Proposed Auditing Standard – Consideration of Materiality in Planning and Performing an Audit

This new proposed standard describes the auditor's responsibilities for applying the concept of materiality, as described by the courts in interpreting federal securities laws, in planning the audit and determining the scope of the audit procedures. Accordingly, the concept of materiality in this new proposed standard reflects the perspective of a reasonable investor.

This new proposed standard contains new and revised requirements for determining materiality for particular accounts or disclosures, determining materiality for individual locations or business units in multi-location engagements, and reassessing materiality and the scope of audit procedures.

D. Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement

This new proposed standard describes the auditor's responsibilities for identifying and assessing risks of material misstatement in an integrated audit and an audit of financial statements only. This proposed standard contains new and revised requirements for performing risk assessment procedures and analyzing identified risks. This proposed standard also incorporates the auditor's responsibilities for identifying and assessing fraud risks so auditors will integrate their consideration of fraud into their risk assessments. The resulting risk assessments should drive the auditor's testing procedures so that auditors focus their attention on the areas of greatest risk.

Establishing more rigorous requirements for identifying and assessing risks can improve auditors' risk assessments and ability to focus on areas of increased risk in audits of financial statements only and in integrated audits. The effectiveness of a risk-based audit depends on whether the auditor identifies the risks of material misstatement and has an appropriate basis for assessing those risks. Inappropriate identification or assessment of risks of material misstatements can lead to overlooking relevant risks to the financial statements, e.g., business conditions that affect asset quality or create pressures to manipulate the financial statements, or assessing risks too low without having an appropriate basis for the assessment. In turn, these situations can lead to misdirected or inadequate audit work.

This new proposed standard employs a top-down approach to risk assessment. Such an approach begins at the financial statement level and with the auditor's overall understanding of the company and its environment and works down to the significant accounts and disclosures and their relevant assertions. Also, the procedures in the new proposed standard are designed to be scalable to companies of varying size and complexity.

In an integrated audit, the risks of material misstatement affect both the audit of financial statements and the audit of internal control, so the risk assessment process described in this new proposed standard is for a single process that applies to both the audit of financial statements and the audit of internal control. The new proposed standard seeks to enhance the integration of the audit of financial statements with the audit of internal control by aligning these risk assessment standards closely with Auditing Standard No. 5. Accordingly, the new proposed standard reflects certain foundational risk assessment principles from Auditing Standard No. 5 that also apply to audits of financial statements. On the other hand, the provisions of this new proposed standard also are designed to be tailored for audits of financial statements only, e.g., the provisions relating to the understanding of internal control over financial reporting.

E. Proposed Auditing Standard – The Auditor's Responses to the Risks of Material Misstatement

The new proposed standard describes the auditor's responsibilities for responding to the risks of material misstatement.

An effective risk-based audit involves tailoring the general conduct of the audit and designing and performing audit procedures in a manner that is appropriately directed to the risks of material misstatement. In developing the original proposed standard, the Board sought to direct auditors to conduct their audits in a manner that appropriately responds to those risks.

RELEASE

The new proposed standard requires the auditor to respond to the risks of material misstatement through overall responses and responses involving the nature, timing, and extent of audit procedures. Overall responses relate to the general conduct of the audit, e.g., appropriate assignment and supervision of engagement team members, incorporating an element of unpredictability into the audit, and making pervasive changes to the audit. AU sec. 316, requires such responses for fraud risks, but the new proposed standard would extend the requirement to apply to risks of material misstatement due to error or fraud. These responses, by their nature, are appropriate for addressing risks of material misstatement due to error or fraud.

The new proposed standard requires the auditor to perform audit procedures that adequately address the assessed risks of material misstatement due to error or fraud. The new proposed standard establishes specific requirements for determining the necessary nature, timing, and extent of substantive procedures and tests of controls (when such tests of controls are performed).

F. Proposed Auditing Standard – Evaluating Audit Results

This new proposed standard describes the auditor's responsibilities regarding evaluating the results of the audit and determining whether sufficient appropriate audit evidence has been obtained to form the opinion(s) to be presented in the auditor's report. This new proposed standard consolidates into one auditing standard the requirements that are currently included in five separate auditing standards[12/] to highlight matters that are important to the auditor's conclusions about the financial statements and the effectiveness of internal control over financial reporting.

This new proposed standard contains several enhancements to the requirements regarding accumulating misstatements and evaluating uncorrected misstatements, including new or revised provisions related to accumulating misstatements, and determining misstatements in accounting estimates. The standard includes new and

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[12/] AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, regarding evaluating audit results, including uncorrected misstatements; AU sec. 316, regarding fraud considerations that are relevant to the evaluating audit results; AU sec. 326, *Evidential Matter,* regarding determining whether sufficient appropriate audit evidence has been obtained; AU sec. 329, *Analytical Procedures*, regarding performing the overall review; and AU sec. 431, *Adequacy of Disclosure in Financial Statements,* regarding the evaluation of financial statement disclosures.

RELEASE

revised requirements regarding evaluating the qualitative aspects of the company's accounting practices, including potential management bias in accounting estimates and selective correction or netting of uncorrected misstatements.

The new proposed standard specifically requires the auditor to evaluate whether the financial statements are fairly presented, in all material respects, in conformity with the applicable financial reporting framework, including whether the financial statements contain the required disclosures. Existing PCAOB standards express such requirements in terms of the auditor's reporting responsibilities instead of required audit procedures.

The new proposed standard also requires the auditor to conclude regarding whether the auditor has obtained sufficient appropriate audit evidence. This requirement includes consideration of whether the auditor's risk assessments remain appropriate, including whether information obtained during the audit indicates previously unrecognized fraud risks.

G. Proposed Auditing Standard – Audit Evidence

This new proposed standard describes the auditor's responsibilities regarding designing and performing audit procedures to obtain sufficient appropriate evidence to support the opinion(s) in the auditor's report. In particular, the new proposed standard discusses the principles for determining the sufficiency and appropriateness of audit evidence, including information produced by the company. It also contains new and revised requirements for situations in which there are inconsistencies in or doubts about audit evidence. The new proposed standard also contains new and revised requirements regarding selecting items for testing.

4. Effective Date

The original proposed standards did not include a proposed effective date for the proposed standards and related amendments. However, commenters provided their views on how the effective date should be determined. Some commenters indicated that the effective date should be set so that it provides sufficient time for audit firms to update their training, methodologies, and tools. Some commenters suggested specific guidelines for determining the effective date of the standards and asked the Board to propose an effective date to seek public comment.

After considering the suggestions of the commenters and the potential timetable for adoption of final risk assessment standards, the Board expects that the standards would be effective for audits of fiscal years beginning on or after December 15, 2010, subject to approval by the SEC.

5. Questions

The Board requests comment on all aspects of the new proposed standards and the related amendments to PCAOB standards. Appendix 9 of this release contains questions on specific aspects of the new proposed standards.

6. Opportunity for Public Comment

The Board will seek comment on the new proposed standards and related amendments for a 75-day period. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, DC 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 026 on the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on March 2, 2010.

* * *

On the 17th day of December, in the year 2009, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Secretary

Proposed Auditing Standard

Audit Risk

Introduction

1. This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit and an audit of financial statements only.[1/]

Objective

2. The objective of the auditor is to conduct the audit of the financial statements in a manner that reduces audit risk to an appropriately low level.

Audit Risk

3. To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement[2/] due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.[3/]

4. In an audit of financial statements, audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial

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[1/] Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* explains how the auditor's consideration of risk affects an audit of internal control over financial reporting.

[2/] Misstatement is defined in paragraph A2 of Appendix A of Proposed Auditing Standard, *Evaluating Audit Results*.

[3/] See AU sec. 110, *Responsibilities and Functions of the Independent Auditor,* and AU sec. 230, *Due Professional Care in the Performance of Work,* for a further discussion of reasonable assurance.

reporting framework.[4/] This risk is a function of the risk of material misstatement and detection risk.

Risk of Material Misstatement

5. The risk of material misstatement refers to the risk that the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial reporting framework. Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* indicates that the auditor should assess the risks of material misstatement at two levels: at the overall financial statement level ("financial statement level") and at the financial statement assertion[5/] level ("assertion level").

6. Risks of material misstatement at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Examples of conditions that might result in risks of material misstatement at the financial statement level include an ineffective control environment, a lack of sufficient capital to continue operations, and declining conditions affecting the company's industry. Risks of material misstatement at the financial statement level may be especially relevant to the auditor's consideration of the risks of material misstatement due to fraud, e.g., deficiencies in the control environment that increase opportunities for management override of controls.

7. Risk of material misstatement at the assertion level consists of the following components:

a. *Inherent risk,* which refers to the susceptibility of an assertion to a misstatement, due to error or fraud, that could be material, individually or in combination with other misstatements, before consideration of any related controls.

b. *Control risk,* which is the risk that a misstatement due to error or fraud that could occur in an assertion and that could be material, individually or in

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[4/] The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

[5/] <u>See</u> Proposed Auditing Standard, *Audit Evidence,* for a description of financial statement assertions.

combination with other misstatements, will not be prevented or detected on a timely basis by the company's internal control. Control risk is a function of the effectiveness of the design and operation of internal control.

8. Inherent risk and control risk are the company's risks; they exist independently of the audit.

Detection Risk

9. In the audit of the financial statements, detection risk is the risk that the procedures performed by the auditor will not detect a misstatement that exists and that could be material, individually or in combination with other misstatements. The level of detection risk is reduced by performing substantive procedures.[6/] Detection risk is affected by the effectiveness of the substantive procedures and of their application by the auditor.

10. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the risk of material misstatement at the assertion level. The lower the risk of material misstatement, the greater the detection risk that can be accepted. Conversely, the greater the risk of material misstatement, the less the detection risk that can be accepted. As the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase.

[6/] Paragraph 37 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement.*

Proposed Auditing Standard

Audit Planning and Supervision

Introduction

1. This standard establishes requirements and provides direction regarding planning the audit and supervising the work of engagement team members.

Objective

2. The objective of the auditor is to plan the audit and supervise the engagement team so that the audit is conducted effectively.

Responsibility of the Engagement Partner for Planning and Supervision

3. The **engagement partner**[1/] is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for planning the audit and for supervising other engagement team members. The engagement partner may seek assistance from appropriate engagement team members in fulfilling these responsibilities.

Planning an Audit

4. The auditor should properly plan the audit. Paragraphs 5-21 describe the auditor's responsibilities for properly planning the audit.

5. Planning the audit includes establishing the overall audit strategy for the engagement and developing an audit plan, which includes, in particular, planned risk assessment procedures and planned responses to the risks of material misstatement. Planning is not a discrete phase of an audit but, rather, a continual and iterative process that might begin shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.

[1/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

Preliminary Engagement Activities

6. The auditor should perform the following activities at the beginning of the audit:

a. Perform procedures regarding the continuance of the client relationship and the specific audit engagement;[2/]

b. Determine compliance with independence and ethics requirements; and

c. Establish an understanding with the client regarding the services to be performed on the engagement.[3/]

> Note: The decision regarding continuance of the client relationship and the determination of compliance with independence and ethics requirements are not limited to preliminary engagement activities and should be re-evaluated with changes in circumstances.

Planning Activities

7. The nature and extent of planning activities that are necessary depend on the size and complexity of the company, the auditor's previous experience with the company, and changes in circumstances that occur during the audit. When developing the audit strategy and audit plan as discussed in paragraphs 8-10, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures:

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;

[2/] Paragraphs .14-.16 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice.* AU sec. 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* explains how the quality control standards relate to the conduct of audits.

[3/] AU sec. 310, *Appointment of the Independent Auditor.*

- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality,[4/] risk, and other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee[5/] or management;
- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;
- Preliminary judgments about the effectiveness of internal control over financial reporting;
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;
- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and
- The relative complexity of the company's operations.

4/ Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit.*

5/ If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

Audit Strategy

8. The auditor should establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

9. In establishing the overall audit strategy, the auditor should take into account:

a. The reporting objectives of the engagement and the nature of the communications required by PCAOB standards,

b. The factors that are significant in directing the activities of the engagement team,

c. The results of preliminary engagement activities and the auditor's evaluation of the important matters in accordance with paragraph 7 of this standard, and

d. The nature, timing, and extent of resources necessary to perform the engagement.

Audit Plan

10. The auditor should develop and document an audit plan that includes a description of:

a. The planned nature, timing, and extent of the risk assessment procedures,[6/]

b. The planned nature, timing, and extent of tests of controls and substantive procedures,[7/] and

c. Other planned audit procedures that are required to be performed so that the engagement complies with PCAOB standards.

Multi-location Engagements

11. In an audit of the financial statements of a company with operations in multiple locations or business units, the auditor should determine the extent to which auditing procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit.

12. Factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures include:

a. The nature and amount of assets, liabilities, and transactions executed at the location or business unit;

b. The materiality of the location or business unit;[8/]

[6/] Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement.*

[7/] Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

[8/] Paragraph 10 of Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit.*

c. The specific risks associated with the location or business unit that present a reasonable possibility[9/] of material misstatement to the company's consolidated financial statements;

d. Whether the risks of material misstatement associated with the location or business unit apply to other locations or business units such that, in combination, they present a reasonable possibility of material misstatement to the company's consolidated financial statements;

e. The degree of centralization of records or information processing;

f. The effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or business unit; and

g. The frequency, timing, and scope of monitoring activities by the company or others at the location or business unit.

> Note: When performing an audit of internal control over financial reporting, refer to paragraphs B10-B16 of Appendix B, Special Topics, of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements,* for considerations when a company has multiple locations or business units.

13. In determining the locations or business units at which to perform auditing procedures, the auditor may take into account relevant activities performed by internal audit or others in accordance with AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* and Auditing Standard No. 5. For example, if the internal auditors' planned procedures include relevant audit work at various locations, the auditor may coordinate work with the internal auditors and reduce the number of locations or

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[9/] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

business units at which the auditor would otherwise need to perform auditing procedures.

14. The direction in paragraph 5 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement,* regarding incorporating an element of unpredictability in the auditing procedures means that the auditor should vary the nature, timing, and extent of audit procedures at locations or business units from year to year.

Changes During the Course of the Audit

15. The auditor should modify the overall audit strategy and the audit plan as necessary if circumstances change significantly during the course of the audit, including due to a revised assessment of the risks of material misstatement or the discovery of a previously unidentified risk of material misstatement.

Persons with Specialized Skill or Knowledge

16. The auditor should determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, apply the planned audit procedures, or evaluate audit results.

> Note: For purposes of the requirements in paragraphs 16-17, the term "specialized skill or knowledge" refers to persons engaged or employed by the auditor who have specialized skill or knowledge.

17. If a person with specialized skill or knowledge employed or engaged by the auditor participates in the audit, the auditor should have sufficient knowledge of the subject matter to be addressed by such a person to enable the auditor to:

a. Communicate the objectives of that person's work;

b. Determine whether that person's procedures meet the auditor's objectives; and

c. Evaluate the results of that person's procedures as they relate to the nature, timing, and extent of other planned audit procedures and the effects on the auditor's report.

18. The requirements for supervision in this standard apply to supervision of a person with specialized skill or knowledge who participates in the audit and is either (a) employed by the auditor or (b) engaged by the auditor to provide

services in a specialized area of accounting or auditing, e.g., an information technology specialist or income tax specialist.

19. AU sec. 336 sets forth the requirements for using the work of persons with specialized skill or knowledge in a field other than accounting or auditing who are engaged by the auditor. Those requirements include, among other things, procedures to understand the objectives and scope of the specialist's work, determine the appropriateness of using the specialist's work for the intended purpose, and evaluate whether the specialist's findings support the related assertions in the financial statements.[10/]

Additional Considerations in Initial Audits

20. The auditor should undertake the following activities before starting an initial audit:

a. Perform procedures regarding the acceptance of the client relationship and the specific audit engagement; and

b. Communicate with the predecessor auditor, in situations in which there has been a change of auditors, in accordance with AU sec. 315, *Communications Between Predecessor and Successor Auditors.*

21. The purpose and objective of planning the audit are the same whether the engagement is an initial audit or a recurring audit engagement. However, for an initial audit, the auditor should determine the additional planning activities necessary to establish an appropriate audit strategy and audit plan, including determining the audit procedures necessary to obtain sufficient appropriate audit evidence regarding the opening balances.

Supervision

22. The auditor should properly supervise the members of the engagement team. Paragraphs 23 and 24 describe the auditor's responsibilities for proper supervision.

23. Elements of proper supervision include the following:

[10/] See AU secs. 336.09 and .12.

a. Informing engagement team members of their responsibilities and the objectives of the procedures that they are to perform, and other matters that could affect the nature, timing, and extent of procedures they are to perform or the evaluation of the results of those procedures, including the nature of the company's business as it relates to their assignments[11/] and possible accounting and auditing issues;

b. Directing engagement team members to bring significant accounting and auditing issues arising during the audit to the engagement partner's attention so those issues can be assessed and appropriate actions can be taken;[12/] and

c. Reviewing the work of engagement team members to evaluate whether the work was performed and documented, the objectives of the procedures were achieved, and the results of the work support the conclusions reached.

24. Factors that affect the necessary level of supervision of other engagement team members include the following:

- The size and complexity of the company
- The nature of the assigned work for each team member, including the procedures to be performed and the controls or accounts and disclosures to be tested

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[11/] Paragraph .06 of AU sec. 230, *Due Professional Care in the Performance of Work,* and Paragraph 5 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement,* establish requirements and provide direction regarding the appropriate assignment of engagement team members.

[12/] In applying due professional care in accordance with AU sec. 230, each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or auditor's report, however those disagreements or concerns may have arisen.

- The risks of material misstatement[13/]
- The knowledge, skill, and ability of each team member

[13/] Paragraph 5 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement,* indicates that the level of supervision of engagement team members is part of the auditor's overall responses to the risks of material misstatement.

APPENDIX A − Definition

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Engagement partner – The member of the engagement team with primary responsibility for the audit.

Proposed Auditing Standard

Consideration of Materiality in Planning and Performing an Audit

Introduction

1. This standard establishes requirements and provides direction regarding the auditor's consideration of materiality in planning and performing an audit.

> Note: Proposed Auditing Standard, *Evaluating Audit Results,* establishes requirements and provides direction regarding the auditor's consideration of materiality in evaluating audit results.

Materiality in the Context of an Audit

2. In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." (TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).) As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him …." TSC Industries, 426 U.S. at 450.

3. To obtain reasonable assurance about whether the financial statements are free of material misstatement, the auditor should design and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements. This includes being alert while performing audit procedures for misstatements that could be material due to quantitative or qualitative factors. Also, the evaluation of uncorrected misstatements in accordance with Proposed Auditing Standard, *Evaluating Audit Results,* requires consideration of both qualitative and quantitative factors.[1/] However, it ordinarily is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors.

[1/] Appendix B of Proposed Auditing Standard, *Evaluating Audit Results.*

4. For integrated audits, paragraph 20 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, states, "In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements."

Objective

5. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing audit procedures.

Considering Materiality When Planning and Performing the Audit

Materiality for the Financial Statements as a Whole

6. When planning the audit, the auditor should establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This includes consideration of the company's earnings and other relevant factors. To determine the nature, timing, and extent of audit procedures, the materiality level for the financial statements as a whole needs to be expressed as a specified amount.

> Note: If financial statements for the audit period are not available, the auditor may establish an initial materiality level based on estimated or preliminary financial statement amounts. In those situations, the auditor should take into account the effects of known or expected changes in the company's financial statements, including significant transactions or adjustments that are expected to be reflected in the financial statements at the end of the period.

Materiality for Particular Accounts or Disclosures

7. The auditor should evaluate whether, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. If so, the auditor should establish separate materiality levels for those accounts or disclosures.

Note: Lesser amounts of misstatements could influence the judgment of a reasonable investor because of qualitative factors, e.g., because of the sensitivity of circumstances surrounding misstatements such as conflicts of interest in related party transactions.

Determining Tolerable Misstatement

8. The auditor should determine the amount or amounts of tolerable misstatement[2/] for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level. The auditor should determine tolerable misstatement at an amount or amounts that reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the financial statements. Accordingly, the amount or amounts of tolerable misstatement should be less than the materiality level for the financial statements as a whole and, if applicable, the materiality level or levels for particular accounts or disclosures.

9. In determining tolerable misstatement and planning and performing audit procedures, the auditor should take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods.

Considerations for Multi-Location Engagements

10. For purposes of the audit of the consolidated financial statements of a company with multiple locations or business units, the auditor should establish the materiality level to be used in performing audit procedures at the locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements. Accordingly, materiality at an individual location cannot exceed, and generally should be less than, materiality for the financial statements as a whole.

[2/] Paragraph .18 of AU sec. 350, *Audit Sampling*, indicates that tolerable misstatement is the maximum amount of misstatement in an account or a class of transactions that may exist without causing the financial statements to be materially misstated.

Considerations as the Audit Progresses

11. The auditor should reassess the established materiality level or levels and tolerable misstatement when, because of changes in the particular circumstances or additional information that comes to the auditor's attention, there is a substantial likelihood that misstatements of amounts that differ significantly from the materiality level or levels that were established initially would influence the judgment of a reasonable investor. Situations in which changes in circumstances would require such reassessment include:

a. The materiality level or levels and tolerable misstatement were established initially based on estimated or preliminary financial statement amounts that differ significantly from actual amounts at the end of the period covered by the financial statements

b. The financial statements used in establishing the materiality level or levels and in determining tolerable misstatement have changed significantly, e.g., because significant adjustments to the financial statements would result in a lower amount for the materiality level or levels or tolerable misstatement.

12. If the auditor's reassessment results in a lower amount for the materiality level or levels or tolerable misstatement than the auditor's initial determination, the auditor should (1) evaluate the effect, if any, of the lower amount or amounts on his or her risk assessments and audit procedures and (2) modify the nature, timing, and extent of audit procedures as necessary to obtain sufficient appropriate audit evidence.

> Note: The reassessment of the materiality level or levels and tolerable misstatement is also relevant to the auditor's evaluation of uncorrected misstatements in accordance with paragraph 17 of Proposed Auditing Standard, *Evaluating Audit Results.*

Proposed Auditing Standard

Identifying and Assessing Risks of Material Misstatement

Introduction

1. This standard establishes requirements and provides direction regarding the process of identifying and assessing risks of material misstatement[1/] of the financial statements.

2. Paragraphs 4-55 discuss the auditor's responsibilities for performing **risk assessment procedures**.[2/] Paragraphs 56-73 discuss identifying and assessing the risks of material misstatement using information obtained from the risk assessment procedures.

Objective

3. The objective of the auditor is to identify and appropriately assess the risks of material misstatement, thereby providing a basis for designing and implementing responses to the risks of material misstatement.

Performing Risk Assessment Procedures

4. The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of the risks of material misstatement due to error or fraud[3/] and to design further audit procedures.[4/]

1/ Paragraphs 5-8 of Proposed Auditing Standard, *Audit Risk*.

2/ Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

3/ AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, discusses fraud, its characteristics, and the types of misstatements due to fraud that are relevant to the audit, i.e., misstatements arising from fraudulent financial reporting and misstatements arising from asset misappropriation.

4/ Proposed Auditing Standard, *Audit Evidence*, describes further audit procedures as consisting of tests of controls and substantive procedures.

5. Risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. For example, external or company-specific factors can affect the judgments involved in determining accounting estimates or create pressures to manipulate the financial statements to achieve certain financial targets. Also, risks of material misstatement may relate to, for example, personnel who lack the necessary financial reporting competencies, information systems that fail to accurately capture business transactions, or financial reporting processes that are not adequately aligned with the requirements in the applicable financial reporting framework. Thus, the audit procedures that are necessary to identify and appropriately assess the risks of material misstatement include consideration of both external factors and company-specific factors. This standard discusses the following risk assessment procedures:

a. Obtaining an understanding of the company and its environment (paragraphs 7-17);

b. Obtaining an understanding of internal control over financial reporting (paragraphs 18-37);

c. Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company (paragraphs 38-42);

d. Performing analytical procedures (paragraphs 43-45);

e. Conducting a discussion among engagement team members regarding the risks of material misstatement (paragraphs 46-50); and

f. Inquiring of the audit committee, management, and others within the company about the risks of material misstatement (paragraphs 51-55).

> Note: This standard describes a top-down approach to identifying and assessing risks of material misstatement. A top-down approach begins at the financial statement level and with the auditor's overall understanding of the company and its environment

and works down to the significant accounts and disclosures and their relevant assertions.[5/]

6. In an integrated audit, the risks of material misstatement of the financial statements are the same for both the audit of internal control over financial reporting and the audit of the financial statements. The auditor's risk assessment procedures should apply to both the audit of internal control over financial reporting and the audit of the financial statements.

Obtaining an Understanding of the Company and Its Environment

7. The auditor should obtain an understanding of the company and its environment ("understanding of the company") to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. Obtaining an understanding of the company includes understanding the following:

a. Relevant industry, regulatory, and other external factors;

b. The nature of the company;

c. The company's selection and application of accounting principles, including related disclosures;

d. The **company's objectives** and strategies and those related **business risks** that might reasonably be expected to result in risks of material misstatement; and

e. The company's measurement and review of its financial performance.

8. While obtaining an understanding of the company, the auditor should evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.

[5/] Paragraph 11 of Proposed Auditing Standard, *Audit Evidence*, discusses financial statement assertions.

Industry, Regulatory, and Other External Factors

9. Obtaining an understanding of relevant industry, regulatory, and other external factors encompasses industry factors including the competitive environment and technological developments; the regulatory environment, including the applicable financial reporting framework[6/] and the legal and political environment;[7/] and external factors including general economic conditions.

Nature of the Company

10. Obtaining an understanding of the nature of the company includes understanding the following:

- The company's organizational structure and management personnel;
- The sources of funding of the company's operations and investment activities, including the company's capital structure, non-capital funding (e.g., subordinated debt or dependencies on supplier financing), and other debt instruments;
- The company's significant investments including equity method investments, joint ventures, and variable interest entities;
- The company's operating characteristics, including its size and complexity;

  Note: The size and complexity of a company might affect the risks of misstatement and how the company addresses those risks.

- The sources of the company's earnings, including the relative profitability of key products and services; and

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6/ The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

7/ See AU sec. 317, *Illegal Acts by Clients*, for additional direction regarding the auditor's consideration of laws and regulations relevant to the audit.

- Key supplier and customer relationships.

> Note: The auditor should take into account the information gathered while obtaining an understanding of the nature of the company when determining the existence of related parties, in accordance with AU sec. 334, *Related Parties.*

11. The auditor also should consider performing the following procedures as part of obtaining an understanding of the company:

- Reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting, e.g., company-issued press releases, company-prepared presentation materials for analysts or investor groups, and analyst reports;

- Observing or reading transcripts of earnings calls and, to the extent publicly available, other meetings with investors or rating agencies;

- Obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements; changes or adjustments to those arrangements and special bonuses; and

- Obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders to identify potentially significant unusual developments (e.g., from Forms 3, 4, 5, 13D, and 13G).

Selection and Application of Accounting Principles

12. The following matters, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles, including related disclosures:

- Significant changes in the company's accounting principles, financial reporting policies, or disclosures and the reasons for such changes

- The financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles

- The accounts or disclosures in which judgment is used in the application of significant accounting principles, especially in determining management's estimates and assumptions

- The effect of significant accounting principles in controversial or emerging areas for which there is a lack of authoritative guidance or consensus

- The methods the company uses to account for significant and unusual transactions

- Financial reporting standards and laws and regulations that are new to the company and when and how the company will adopt such requirements

13. As part of obtaining an understanding of the company's selection and application of accounting principles, including related disclosures, the auditor should evaluate whether the company's selection and application of accounting principles is appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the relevant industry. Also, to identify and assess risks of material misstatement related to omitted or incomplete disclosures, the auditor should identify the necessary disclosures for the company's financial statements.

Company Objectives, Strategies, and Related Business Risks

14. The purpose of obtaining an understanding of the company's objectives, strategies, and related business risks is to identify those business risks that could reasonably be expected to result in material misstatement of the financial statements.

15. The following are examples of situations in which business risks might result in material misstatement of the financial statements:

- Industry developments (a potential related business risk might be, for example, that the company does not have the personnel or expertise to deal with the changes in the industry.)

- New products and services (a potential related business risk might be, for example, that the new product or service will not be successful.)

- Use of information technology (a potential related business risk might be, for example, that systems and processes are incompatible.)

- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation.)

- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated.)

- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation.)

- Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the company's inability to meet requirements.)

- Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure.)

> Note: Some relevant business risks might be identified through other risk assessment procedures, such as obtaining an understanding of the nature of the company and understanding industry, regulatory, and other external factors.

Company Performance Measures

16. The purpose of obtaining an understanding of the company's performance measures is to identify those performance measures, whether external or internal, that affect the risks of material misstatement.

17. The following are examples of performance measures that might affect the risks of material misstatement:

- Measures that form the basis for contractual commitments or incentive compensation arrangements
- Measures used by external parties, such as analysts and rating agencies, to review the company's performance
- Measures the company uses to monitor its operations that highlight unexpected results or trends prompting management to investigate their cause and take corrective action, including correction of misstatements

> Note: Smaller companies might have less formal processes to measure and review financial performance. In such cases, the auditor might identify relevant performance measures by considering the information that the company uses to manage the business.

Obtaining an Understanding of Internal Control Over Financial Reporting

18. The auditor should obtain a sufficient understanding of each component[8/] of internal control over financial reporting ("understanding of internal control") to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.

19. The nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company;[9/] the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the

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[8/] Paragraphs 21-22 of this standard discuss components of internal control.

[9/] Paragraph 13 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with and Audit of Financial Statements*, states, "The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its control objectives. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks."

company's use of information technology ("IT"); the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting.

> Note: The auditor also might obtain an understanding of certain controls that are not part of internal control over financial reporting, e.g., controls over the completion and accuracy of operating or other non-financial information used as audit evidence.[10/]

> Note: Walkthroughs, as described in paragraphs 64-65, may be performed in connection with obtaining an understanding of internal control.

20. Obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.

> Note: Procedures the auditor performs to obtain evidence about design effectiveness include inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

> Note: Determining whether a control has been implemented means determining whether the control exists and whether the company is using it. The procedures to determine whether a control has been implemented may be performed in connection with the evaluation of its design. Procedures performed to determine whether a control has been implemented include inquiry of company personnel, in combination with observation of the application of controls or inspection of documentation.

21. Internal control over financial reporting can be described as consisting of the following components:[11/]

[10/] Paragraph 10 of Proposed Auditing Standard, *Audit Evidence.*

[11/] Different internal control frameworks use different terms and approaches to describe the components of internal control over financial reporting.

- The control environment
- The company's risk assessment process
- Information and communication
- Control activities
- Monitoring of controls

22. Management might use an internal control framework that differs from the components identified in the preceding paragraph when establishing and maintaining the company's internal control over financial reporting. In evaluating the design of controls and determining whether they have been implemented in an audit of financial statements only, the auditor may use the framework used by management or another suitable, recognized framework.[12/] For integrated audits, Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements,* states, "The auditor should use the same suitable, recognized control framework to perform the audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting."[13/] If the auditor uses a suitable, recognized internal control framework with components that differ from those listed in the preceding paragraph, the auditor should adapt the requirements in paragraphs 23-35 of this standard to conform to the components in the framework used.

Control Environment

23. The auditor should obtain an understanding of the company's control environment, including the policies and actions of management, the board, and the audit committee concerning the company's control environment.

24. Obtaining an understanding of the control environment includes assessing the following:

[12/] See Securities Exchange Act Release No. 34-47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

[13/] Paragraph 5 of Auditing Standard No. 5.

- Whether management's philosophy and operating style promote effective internal control over financial reporting;

- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and

- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

> Note: In an audit of financial statements only, this assessment may be based on the evidence obtained in understanding the control environment, in accordance with paragraph 23, and the other relevant knowledge possessed by the auditor. In an integrated audit of financial statements and internal control over financial reporting, paragraph 25 of Auditing Standard No. 5 describes the auditor's responsibility for evaluating the control environment.

25. If the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor, as discussed in paragraphs 66-67.

The Company's Risk Assessment Process

26. The auditor should obtain an understanding of management's process for:

a. Identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud ("fraud risks"),

b. Assessing the likelihood and significance of misstatements resulting from those risks, and

c. Deciding about actions to address those risks.

27. Obtaining an understanding of the company's risk assessment process includes obtaining an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.

Information and Communication

28. *Information System Relevant to Financial Reporting.* The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following:

a. The classes of transactions in the company's operations that are significant to the financial statements;

b. The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported;

c. The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions;

d. How the information system captures events and conditions, other than transactions,[14/] that are significant to the financial statements; and

e. The period-end financial reporting process.

Note: Appendix B discusses additional considerations regarding manual and automated systems and controls.

29. A company's business processes are the activities designed to:

a. Develop, purchase, produce, sell and distribute a company's products and/or services;

b. Record information, including accounting and financial reporting information; and

c. Ensure compliance with laws and regulations relevant to the financial statements.

[14/] Examples of such events and conditions include depreciation and amortization and conditions affecting the recoverability of assets.

30. Obtaining an understanding of the company's business processes, assists the auditor in obtaining an understanding of how transactions are initiated, authorized, processed, and recorded.

31. A company's period-end financial reporting process, as referred to in paragraph 28e, includes the following:

- Procedures used to enter transaction totals into the general ledger;
- Procedures related to the selection and application of accounting policies;[15/]
- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- Procedures used to record recurring and nonrecurring adjustments to the annual financial statements (and quarterly financial statements, if applicable); and
- Procedures for preparing annual financial statements and related disclosures (and quarterly financial statements, if applicable).

32. *Communication.* The auditor should obtain an understanding of how the company communicates financial reporting roles and responsibilities and significant matters relating to financial reporting including:

- Communications between management, the audit committee and the board; and
- Communications to external parties, including regulatory authorities and shareholders.

Control Activities

33. The auditor should obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures, as described in paragraph 18.[16/]

[15/] See paragraphs 12-13 of this standard.

[16/] See also paragraph B5 of Appendix B.

Monitoring of Controls

34. The auditor should obtain an understanding of the major types of activities that the company uses to monitor the effectiveness of its internal control over financial reporting and how the company initiates corrective actions related to its controls.

> Note: In some companies, internal auditors or others performing an equivalent function contribute to the monitoring of controls. AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* establishes requirements and provides direction regarding the auditor's consideration and use of the work of the internal audit function.

35. An understanding of the company's monitoring activities includes understanding the source of the information used in the monitoring activities.

Relationship of Understanding of Internal Control to Tests of Controls

36. The preceding paragraphs discuss the auditor's responsibilities for obtaining an understanding of internal control as part of performing risk assessment procedures. The objective of obtaining an understanding of internal control, as discussed in paragraph 18, is different from testing controls for the purpose of assessing control risk[17/] or for the purpose of expressing an opinion on internal control over financial reporting in the audit of internal control over financial reporting.[18/] The auditor may obtain an understanding of internal control concurrently with performing tests of controls if he or she obtains sufficient appropriate evidence to achieve the objectives of both procedures. Also, the auditor should take into account the evidence obtained from understanding internal control when assessing control risk and, in the audit of internal control over financial reporting, forming conclusions about the effectiveness of controls.

37. *Relationship of Understanding of Internal Control to Evaluating Entity-Level Controls in an Audit of Internal Control Over Financial Reporting.* Paragraph 22 of Auditing Standard No. 5 states, "The auditor must test those entity-level controls that are important to the auditor's conclusion about whether

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17/ Paragraphs 16-31 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement.*

18/ Paragraph B1 of Auditing Standard No. 5.

the company has effective internal control over financial reporting." The procedures performed to obtain an understanding of certain components of internal control in accordance with this standard, e.g., the control environment, the company's risk assessment process, information and communication, and monitoring of controls, might provide evidence that is relevant to the auditor's evaluation of entity-level controls.[19/] The auditor should take into account the evidence obtained from understanding internal control when determining the nature, timing, and extent of procedures necessary to support the auditor's conclusions about the effectiveness of entity-level controls in the audit of internal control over financial reporting.

Considering Information from the Client Acceptance and Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements

38. *Client Acceptance and Retention and Audit Planning Activities.* The auditor should evaluate whether information obtained from the client acceptance and retention process or audit planning activities is relevant to identifying risks of material misstatement. Risks of material misstatement identified during those activities should be assessed as discussed in paragraphs 56-73 of this standard.

39. *Past Audits.* In subsequent years, the auditor should incorporate knowledge obtained during past audits into the auditor's process for identifying risks of material misstatement, including when identifying significant ongoing matters that affect the risks of material misstatement or determining how changes in the company or its environment affect the risks of material misstatement, as discussed in paragraph 8 of this standard.

40. If the auditor plans to limit the nature, timing, or extent of his or her risk assessment procedures by relying on information from past audits, the auditor should determine that the prior-years' information remains relevant and reliable.

41. *Other Engagements.* When the auditor has performed a review of interim financial information in accordance with AU sec. 722, *Interim Financial Information,* the auditor should evaluate whether information obtained during the

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[19/] The entity-level controls listed in paragraph 24 of Auditing Standard No. 5 include controls related to the control environment; the company's risk assessment process; centralized processing and controls; controls over the period-end financial reporting process; and controls to monitor other controls.

review is relevant to identifying risks of material misstatement in the year-end audit.

42. If the auditor has obtained other information relevant to identifying risks of material misstatement through other engagements performed for the company, the auditor should take that into account in identifying risks of material misstatement.[20/]

Performing Analytical Procedures

43. The auditor should perform analytical procedures that are designed to:

a. Enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior year-end; and

b. Identify areas that might represent specific risks relevant to the audit, including the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.

44. In applying analytical procedures as risk assessment procedures, the auditor should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud. Also, when the auditor has performed a review of interim financial information in accordance with AU sec. 722, he or she should take into account the analytical procedures applied in that review when designing and applying analytical procedures as risk assessment procedures.

45. When applying an analytical procedure, the auditor should use his or her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure.[21/] When comparison of those expectations with relationships derived from recorded amounts yields

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[20/] Paragraph 7 of Proposed Auditing Standard, *Audit Planning and Supervision.*

[21/] Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

unusual or unexpected results, the auditor should take into account those results in identifying the risks of material misstatement.

> Note: Analytical procedures performed as risk assessment procedures often use data aggregated at a high level and ordinarily are not designed with the level of precision necessary for substantive analytical procedures.

Conducting a Discussion among Engagement Team Members Regarding Risks of Material Misstatement

46. The key engagement team members should discuss (1) the company's selection and application of accounting principles, including related disclosure requirements; and (2) the susceptibility of the company's financial statements to material misstatement due to error or fraud.[22/]

> Note: The key engagement team members should discuss the potential for material misstatement due to fraud either as part of the discussion regarding risks of material misstatement or in a separate discussion. See paragraphs 49-50 of this standard.

47. Key engagement team members include all engagement team members who have significant engagement responsibilities, including the engagement partner. The manner in which the discussion may be conducted depends on the individuals involved and the circumstances of the engagement. For example, if the audit involves more than one location, there could be multiple discussions with team members in differing locations. The engagement partner or other key engagement team members should communicate the important matters from the discussion to engagement team members who are not involved in the discussion.

> Note: If the audit is performed entirely by the engagement partner, that engagement partner, having personally conducted the planning of the audit, is responsible for considering the susceptibility of the company's financial statements to material misstatement.

[22/] For example, the financial statements might be susceptible to misstatement through omission of required disclosures or presentation of incorrect or incomplete disclosures.

48. Communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change.[23/]

Discussion of the Potential for Material Misstatement Due to Fraud

49. The discussion among the key engagement team members about the potential for material misstatement due to fraud should occur with an attitude that includes a questioning mind, and the key engagement team members should set aside any prior beliefs they might have that management is honest and has integrity. The discussion among the key engagement team members should include:

- An exchange of ideas, or "brainstorming," among the key engagement team members, including the engagement partner, about how and where they believe the company's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the company could be misappropriated, including (a) the susceptibility of the financial statements to material misstatement through related party transactions and (b) how fraud might be perpetrated or concealed by omitting or presenting incomplete disclosures

- A consideration of the known external and internal factors affecting the company that might (a) create incentives or pressures for management and others to commit fraud, (b) provide the opportunity for fraud to be perpetrated, and (c) indicate a culture or environment that enables management to rationalize committing fraud

- A consideration of the risk of management override

- A consideration of the potential audit responses to the susceptibility of the company's financial statements to material misstatement due to fraud

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[23/] See also paragraph 29 of Proposed Auditing Standard, *Evaluating Audit Results*.

50. The auditor should emphasize the following matters to all engagement team members:

- The need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, as described in paragraph 13 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*

- The need to be alert for information or other conditions (such as those presented in paragraph C1 of Proposed Auditing Standard, *Evaluating Audit Results*) that might affect the assessment of fraud risks

- If information or other conditions indicate a material misstatement due to fraud might have occurred, the need to probe the issues, acquire additional evidence as necessary, and consult with other team members and, if appropriate, others in the firm including specialists[24/]

Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

51. The auditor should make inquiries of the audit committee (or its chair), management, the internal audit function, and others within the company who might reasonably be expected to have information that is important to the identification and assessment of risks of material misstatement.

Note: The auditor's inquiries about risks of material misstatement should include inquiries regarding fraud risks.

52. The auditor should use his or her knowledge of the company and its environment as well as information from other risk assessment procedures to determine the nature of those inquiries.

[24/] Paragraphs 20-23 of Proposed Auditing Standard, *Evaluating Audit Results,* establish further requirements for evaluating whether misstatements might be indicative of fraud and determining the necessary procedures to be performed in those situations.

Inquiries Regarding Fraud Risks

53. The auditor's inquiries regarding fraud risks should include the following:

a. Inquiries of management regarding:

(1) Whether management has knowledge of fraud, alleged fraud or suspected fraud affecting the company;

(2) Management's process for identifying and responding to the risks of fraud in the company, including any specific fraud risks the company has identified or account balances or disclosures for which a fraud risk is likely to exist, and the nature, extent, and frequency of management's fraud risk assessment process;

(3) Controls that the company has established to address fraud risks the company has identified, or that otherwise help to prevent and detect fraud, including how management monitors those controls;

(4) For a company with multiple locations (a) the nature and extent of monitoring of operating locations or business segments and (b) whether there are particular operating locations or business segments for which a risk of fraud might be more likely to exist;

(5) Whether and how management communicates to employees its views on business practices and ethical behavior;

(6) Whether management has received tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, management's responses to such tips and complaints; and

(7) Whether management has reported to the audit committee on how the company's internal control serves to prevent and detect material misstatements due to fraud.

b. Inquiries of the audit committee, or equivalent, or its chair regarding:

(1) The audit committee's views about the risks of fraud;

(2) Whether the audit committee has knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

(3) Whether the audit committee is aware of tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program) and, if so, the audit committee's responses to such tips and complaints; and

(4) How the audit committee exercises oversight of the company's assessment of the risks of fraud and the establishment of mitigating controls.

c. If the company has an internal audit function, inquiries of appropriate internal audit personnel regarding:

(1) The internal auditors' views about the risks of fraud;

(2) Whether the internal auditors have knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

(3) Whether internal auditors have performed procedures to identify or detect fraud during the year, and whether management has satisfactorily responded to the findings resulting from those procedures; and

(4) Whether the internal auditor is aware of instances of management override of controls and the nature and circumstances of such overrides.

54. In addition to the inquiries outlined in the preceding paragraph, the auditor should inquire of others within the company about their views regarding fraud risks, including, in particular, whether they have knowledge of fraud, alleged fraud, or suspected fraud. The auditor should identify other individuals within the company to whom inquiries should be directed by considering whether others in the company might have additional knowledge about fraud, alleged or suspected

fraud or be able to corroborate risks of fraud identified in discussions with management or the audit committee. Examples of others within the company to whom inquiries might be directed include:

- Employees with varying levels of authority within the entity, including, for example, entity personnel with whom the auditor comes into contact during the course of the audit (a) in obtaining an understanding of internal control, (b) in observing inventory or performing cutoff procedures, or (c) in obtaining explanations for significant differences identified when performing analytical procedures

- Operating personnel not directly involved in the financial reporting process

- Employees involved in initiating, recording, or processing complex or unusual transactions, e.g., a sales transaction with multiple elements or a significant related party transaction

- In-house legal counsel

55. When evaluating management's responses to inquiries about fraud risks, the auditor should take into account that management is often in the best position to commit fraud in determining when it is necessary to corroborate management's responses. Also, the auditor should obtain evidence to address inconsistencies in responses to the inquiries.

Identifying and Assessing the Risks of Material Misstatement

56. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. In identifying and assessing risks of material misstatement, the auditor should:

a. Identify risks of misstatement due to error or fraud using information obtained from the risk assessment procedures (as discussed in paragraphs 4-55) and considering the characteristics of the accounts and disclosures in the financial statements.

    Note: Factors relevant to identifying fraud risks are discussed in paragraphs 67-70.

b. Evaluate whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions.

c. Evaluate the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected.

> Note: In identifying and assessing risks at the assertion level, the auditor should evaluate how risks at the financial statement level could affect risks of misstatement at the assertion level.

d. Assess the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements.

> Note: In assessing the likelihood and magnitude of potential misstatement, the auditor may take into account the planned degree of reliance on controls selected to test.[25/]

e. Identify significant accounts and disclosures[26/] and their relevant assertions[27/] (paragraphs 57-61).

[25/] Paragraphs 16-34 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement.*

[26/] Paragraph A10 of Auditing Standard No. 5 states, "An account or disclosure is a significant account or disclosure if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls."

[27/] Paragraph A9 of Auditing Standard No. 5 states, "A relevant assertion is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion

Note: The determination of whether an account or disclosure is significant or whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

Note: Paragraphs 62-63 discuss the auditor's responsibilities for understanding likely sources of misstatement in relation to relevant assertions.

f. Determine whether any of the identified and assessed risks of material misstatement are significant risks (paragraph 71).

Note: The determination of whether a risk of material misstatement is a **significant risk** is based on inherent risk, without regard to the effect of controls.

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

57. To identify significant accounts and disclosures and their relevant assertions in accordance with paragraph 56e, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include:

- Size and composition of the account;
- Susceptibility to misstatement due to error or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;

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is a relevant assertion is based on inherent risk, without regard to the effect of controls."

- Exposure to losses in the account;
- Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- Existence of related party transactions in the account; and
- Changes from the prior period in account and disclosure characteristics.

58. As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.

59. The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the audit of internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits.

> Note: In the financial statement audit, the auditor might perform substantive auditing procedures on financial statement accounts, disclosures and assertions that are not determined to be significant accounts and disclosures and relevant assertions.[28/]

60. The components of a potential significant account or disclosure might be subject to significantly differing risks.

[28/] This is because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high (see paragraphs 12-14 of Proposed Auditing Standard, *Evaluating Auditing Results,* for further discussion about undetected misstatement) or as a means of introducing unpredictability in the procedures performed (see paragraph 61 of Auditing Standard No. 5 and paragraph 5 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement,* for further discussion about unpredictability of auditing procedures).

61. When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements.

Understanding Likely Sources of Misstatement

62. To further understand the likely sources of potential misstatements,[29/] the auditor should achieve the following objectives:

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded;

- Verify that the auditor has identified the points within the company's processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material;

- Identify the controls that management has implemented to address these potential misstatements; and

- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.

63. The auditor also should understand how IT affects the company's flow of transactions. (See Appendix B.)

> Note: The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify significant accounts and disclosures and their relevant assertions, and the controls to test, as well as to assess risk and allocate audit effort.

64. *Performing Walkthroughs.* Performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 62. In performing a

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[29/] In an integrated audit, the procedures to achieve the objectives in this paragraph also apply to the selection of controls to test in the audit of internal control over financial reporting. See paragraph 34 of Auditing Standard No. 5.

walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

65. In performing a walkthrough, at the points at which important processing procedures occur, the auditor questions the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions, combined with the other walkthrough procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the auditor to gain an understanding of the different types of significant transactions handled by the process.

Factors Relevant to Identifying Fraud Risks

66. The auditor should evaluate whether the information gathered from the risk assessment procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks. Fraud risk factors are events or conditions that indicate (1) an incentive or pressure to perpetrate fraud, (2) an opportunity to carry out the fraud, or (3) an attitude or rationalization that justifies the fraudulent action. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances in which fraud exists. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are listed in AU sec. 316.85. These illustrative risk factors are classified based on the three conditions discussed in the preceding paragraph, which generally are present when fraud exists.

> Note: The factors listed in AU sec. 316.85 cover a broad range of situations and are only examples. Accordingly, the auditor might identify additional or different fraud risk factors.

67. The auditor should not assume that all of the conditions discussed in paragraph 66 must be observed or evident to conclude that a fraud risk exists. The auditor might conclude that a fraud risk exists even when only one of these three conditions is present.

68. *Consideration of the Risk of Omitted or Incomplete Disclosures.* The auditor's evaluation of fraud risk factors in accordance with paragraph 66 should include evaluation of how fraud could be perpetrated or concealed through omitting or presenting incomplete disclosures.

69. *Presumption of Fraud Risk Involving Improper Revenue Recognition.* The auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.

70. *Consideration of the Risk of Management Override of Controls.* The auditor's identification of fraud risks should include the risk of management override of controls.

> Note: Controls over management override are important to effective internal control over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override.

Factors Relevant to Identifying Significant Risks

71. Factors that should be evaluated in determining which risks are significant risks include:

a. Whether the risk is a fraud risk;

    Note: A fraud risk is a significant risk.

b. Whether the risk is related to recent significant economic, accounting, or other developments;

c. The complexity of transactions;

d. Whether the risk involves significant transactions with related parties;

e. The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

f. Whether the risk involves significant transactions that are outside the normal course of business for the company, or that otherwise appear to be unusual due to their timing, size or nature.

Further Consideration of Controls

72. When the auditor has determined that a significant risk, including a fraud risk, exists, the auditor should evaluate the design of the company's controls that are intended to address fraud risks and other significant risks and determine whether those controls have been implemented, if the auditor has not already done so when obtaining an understanding of internal control over financial reporting, as described in paragraphs 18-35 of this standard.

Note: Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, provides direction on the auditor's response to fraud risks and other significant risks.

73. Controls that address fraud risks include (a) specific controls designed to mitigate specific risks of fraud, e.g., controls to address risks of intentional misstatement of specific accounts and (b) controls designed to prevent, deter, and detect fraud, e.g., controls to promote a culture of honesty and ethical behavior.[30/] Such controls also include those that address the risk of management override of other controls.

Revision of Risk Assessment

74. The auditor's assessment of the risks of material misstatement, including fraud risks, should be ongoing throughout the audit. When the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor

[30/] AU sec. 316.88 and paragraph 14 of Auditing Standard No. 5 present examples of controls that address fraud risks.

should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.[31/]

[31/] See also Paragraph 46 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Business risks – Risks that result from significant conditions, events, circumstances, actions or inactions that could adversely affect a company's ability to achieve its objectives and execute its strategies. Business risks also might result from setting inappropriate objectives and strategies or from change or complexity in the company's operations or management.

A3. Company's objectives – The overall plans for the company as established by management or the board of directors. Strategies are the approaches by which management intends to achieve its objectives.

A4. Risk assessment procedures – The procedures performed by the auditor to obtain information for identifying and assessing the risks of material misstatement in the financial statements.[32/]

A5. Significant risk – A risk of material misstatement that requires special audit consideration.

[32/] Risk assessment procedures by themselves do not provide sufficient appropriate evidence on which to base an audit opinion.

APPENDIX B – Consideration of Manual and Automated Systems and Controls

B1. While obtaining an understanding of the company's information system related to financial reporting, the auditor should obtain an understanding of how the company uses information technology ("IT") and how IT affects the financial statements. The auditor also should obtain an understanding of the extent of manual controls and automated controls used by the company, including the IT general controls that are important to the effective operation of the automated controls. That information should be taken into account in assessing the risks of material misstatement.

> Note: Paragraphs 16-18 of Proposed Auditing Standard, *Audit Planning and Supervision,* establish requirements and provides direction regarding (1) the determination as to whether specialized IT knowledge or skills are needed on an audit and (2) the use of a person with specialized IT knowledge and skills employed or engaged by the auditor's firm.

B2. Controls in a manual system might include procedures such as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items.

B3. Alternatively, a company might use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format would replace paper documents. When IT is used to initiate, record, process, and report transactions, the IT systems and programs may include controls related to the relevant assertions of significant accounts and disclosures or may be critical to the effective functioning of manual controls that depend on IT.

B4. The auditor should obtain an understanding of specific risks to a company's internal control over financial reporting resulting from IT. Examples of such risks include:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both

- Unauthorized access to data that might result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions or inaccurate recording of transactions. Particular risks might arise when multiple users access a common database

- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down segregation-of-duties
- Unauthorized changes to data in master files
- Unauthorized changes to systems or programs
- Failure to make necessary changes to systems or programs
- Inappropriate manual intervention
- Potential loss of data or inability to access data as required

B5. In obtaining an understanding of the company's control activities, the auditor should obtain an understanding of how the company has responded to risks arising from IT.

B6. When a company uses manual elements in internal control systems, the auditor should design procedures to test the consistency in the application of manual controls.

Proposed Auditing Standard

The Auditor's Responses to the Risks of Material Misstatement

Introduction

1. This standard establishes requirements and provides direction regarding designing and implementing appropriate responses to the risks of material misstatement.

Objective

2. The objective of the auditor is to address the risks of material misstatement through appropriate overall audit responses and audit procedures.

Responding to the Risks of Material Misstatement

3. To meet the objective of this standard, the auditor must design and implement responses that address the risks of material misstatement that are identified and assessed in accordance with Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement.*

4. This standard discusses the following types of audit responses:

   a. Responses that have an overall effect on how the audit is conducted ("overall responses"), as described in paragraphs 5-7.

   b. Responses involving the nature, timing, and extent of the audit procedures to be performed, as described in paragraphs 8-46.

Overall Responses

5. The auditor should design and implement overall responses to address the assessed risks of material misstatement as follows:

   a. *Making appropriate assignments of significant engagement responsibilities.* The knowledge, skill, and ability of engagement team members with significant engagement responsibilities should be commensurate with the assessed risks of material misstatement.

b. *Providing a level of supervision that is appropriate for the circumstances, including, in particular, the assessed risks of material misstatement.* (See paragraphs 21-24 of Proposed Auditing Standard, *Audit Planning and Supervision*.)

c. *Incorporating elements of unpredictability in the selection of audit procedures to be performed.* As part of the auditor's response to the assessed risks of material misstatement, including the assessed risks of material misstatement due to fraud ("fraud risks"), the auditor should incorporate an element of unpredictability in the selection of auditing procedures to be performed from year to year. Examples of ways to incorporate an element of unpredictability are (a) performing audit procedures related to accounts, disclosures and assertions that would not otherwise be tested based on their amount or the auditor's assessment of risk; (b) varying the timing or location of the audit procedures; (c) selecting items for testing that have lower amounts or are otherwise outside customary selection parameters; and (d) performing audit procedures on an unannounced basis.

d. *Evaluating the company's selection and application of significant accounting principles.* The auditor should evaluate whether the company's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions[1/] are indicative of bias that could lead to material misstatement of the financial statements.

> Note: Paragraph .11 of AU sec. 380, *Communication With Audit Committees,* discusses auditor judgments about the quality of a company's accounting principles.

6. The auditor also should evaluate whether it is necessary to make pervasive changes to the nature, timing, or extent of audit procedures to adequately address the assessed risks of material misstatement. Examples of such pervasive changes include performing substantive procedures at the period

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[1/] Paragraphs 12-13 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* discuss the auditor's responsibilities regarding obtaining an understanding of the company's selection and application of accounting principles.

end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.

7. Due professional care requires the auditor to exercise professional skepticism.[2/] Accordingly, the auditor's responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence.[3/] Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence. Examples of the application of professional skepticism in response to the assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or employed by the auditor, or examination of documentation from independent sources.

Responses Involving the Nature, Timing, and Extent of Audit Procedures

8. The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement due to error or fraud for each relevant assertion of each significant account and disclosure.

9. In designing the audit procedures to be performed, the auditor should:

a. Obtain more persuasive audit evidence the higher the auditor's assessment of risk;

[2/] Paragraphs .07-.09 of AU sec. 230, *Due Professional Care in the Performance of Work.*

[3/] Paragraph .13 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*

b. Take into account the types of potential misstatements that could result from the identified risks and the likelihood and magnitude of potential misstatement;[4/]

c. In an integrated audit, design the testing of controls to accomplish the objectives of both audits simultaneously –

(1) To obtain sufficient evidence to support the auditor's control risk[5/] assessments for purposes of the audit of financial statements;[6/] and

(2) To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year end.

10. The audit procedures performed in response to the assessed risks of material misstatement can be classified into two categories – tests of controls and substantive procedures.[7/] Paragraphs 16-35 of this standard discuss tests of controls, and paragraphs 36-46 discuss substantive procedures.

Note: Paragraphs 16-17 discuss when tests of controls are necessary in a financial statement audit. Ordinarily, tests of controls are performed for relevant assertions for which the auditor chooses to rely on controls to modify his or her substantive procedures.

[4/] For example, potential misstatements regarding disclosures include omission of required disclosures or presentation of incorrect or incomplete disclosures.

[5/] See paragraph 7.b. of Proposed Auditing Standard, *Audit Risk,* for a definition of control risk.

[6/] For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

[7/] Substantive procedures consist of (a) tests of details of accounts and disclosures and (b) substantive analytical procedures.

Responses to Significant Risks

11. For significant risks, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed risks.

> Note: Paragraph 71 of Proposed Auditing Standard, *Identifying and Assessing the Risks of Material Misstatement,* discusses identification of significant risks. Paragraphs 12-15 of this standard discuss the auditor's responses to assessed fraud risks.

Responses to Fraud Risks

12. The audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected.

> Note: If the auditor identifies deficiencies in controls that are intended to address assessed fraud risks, the auditor should take into account those deficiencies when developing his or her response to those fraud risks.

> Note: Paragraphs 14-15 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements,* establish requirements and provide direction regarding addressing assessed fraud risks in the audit of internal control over financial reporting.

13. *Addressing Fraud Risks in the Audit of Financial Statements.* In the audit of financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks. The auditor also may perform tests of controls intended to address the assessed fraud risks that are selected for testing in accordance with paragraphs 16-17 of this standard.

14. The following are examples of ways in which planned audit procedures may be modified to address assessed fraud risks:

a. Changing the *nature* of audit procedures to obtain evidence that is more reliable or to obtain additional corroborative information.

b. Changing the *timing* of audit procedures to be closer to the end of the period or to the points during the period in which fraudulent transactions are more likely to occur.

c. Changing the *extent* of the procedures applied to obtain more evidence, e.g., by increasing sample sizes or applying computer-assisted audit techniques to all of the items in an account.

> Note: Paragraphs .54-.67 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, provide further examples of and additional direction on responses to assessed fraud risks relating to fraudulent financial reporting (e.g., revenue recognition, inventory quantities, and management estimates) and misappropriation of assets in the audit of financial statements.

15. Also, AU sec. 316 indicates that the auditor should perform audit procedures to specifically address the risk of management override of controls including:

a. Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud (AU secs. 316.58-.62),

b. Reviewing accounting estimates for biases that could result in material misstatement due to fraud (AU secs. 316.63-.65), and

c. Evaluating the business rationale for significant unusual transactions (AU secs. 316.66-.67).

Testing Controls

Testing Controls in an Audit of Financial Statements

16. *Controls to be Tested.* If the auditor plans to assess control risk at less than the maximum by relying on controls,[8/] and the nature, timing, and extent of

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[8/] Reliance on controls, when appropriate, allows the auditor to assess control risk at less than the maximum, which results in a lower assessed planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire **period of reliance**.[9/] However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

17. Also, tests of controls must be performed in the audit of financial statements for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence and when necessary to support the auditor's reliance on the completeness and accuracy of financial information used in performing other audit procedures.[10/]

> Note*:* When a significant amount of information supporting one or more relevant assertions is electronically initiated, recorded, processed, or reported, it might be impossible to design effective substantive tests that, by themselves, would provide sufficient appropriate evidence regarding the assertions. For such assertions, significant audit evidence may be available only in electronic form. In such cases, the sufficiency and appropriateness of the audit evidence usually depend on the effectiveness of controls over their accuracy and completeness. Furthermore, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively.

18. *Evidence about the Effectiveness of Controls in the Audit of Financial Statements.* In designing and performing tests of controls for the audit of financial statements, the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The auditor should obtain more persuasive audit

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risk of material misstatement. In turn, this might allow the auditor to modify the nature, timing, and extent of planned substantive procedures.

[9/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

[10/] See paragraph 10 of Proposed Auditing Standard, *Audit Evidence,* and paragraph .16 of AU sec. 329, *Substantive Analytical Procedures.*

evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. The auditor also should obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.

Testing Design Effectiveness

19. The auditor should test the design effectiveness of the controls selected for testing by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect error or fraud that could result in material misstatements in the financial statements.

> Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.

20. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.[11/]

Testing Operating Effectiveness

21. The auditor should test the operating effectiveness of a control selected for testing by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

[11/] Paragraphs 64-65 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatements*, provide direction on performing a walkthrough.

22. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Obtaining Evidence from Tests of Controls

23. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing might provide sufficient evidence in relation to the degree of reliance in an audit of financial statements.

> Note: To obtain evidence about whether a control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures.

Nature of Tests of Controls

24. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control.

> Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.

25. The nature of the tests of controls that will provide appropriate evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

> Note: A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain controls,

might provide sufficient evidence about whether the control is effective.

Extent of Tests of Controls

26. The more extensively a control is tested, the greater the evidence obtained from that test.

27. Matters that could affect the necessary extent of testing of a control in relation to the degree of reliance on a control include the following:

- The frequency of the performance of the control by the company during the audit period
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control
- The expected rate of deviation from a control
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control
- The extent to which audit evidence is obtained from tests of other controls related to the assertion
- The nature of the control, including, in particular, whether it is a manual control or an automated control
- For an automated control, the effectiveness of relevant general controls

> Note: AU sec. 350, *Audit Sampling,* provides direction on the use of sampling in tests of controls.

Timing of Tests of Controls

28. The timing of tests of controls relates to when the evidence about the operating effectiveness of the controls is obtained and the period of time to which it applies. Paragraph 16 indicates that the auditor must obtain evidence that the

controls selected for testing are designed effectively and operated effectively during the entire period of reliance.

29. *Using Audit Evidence Obtained during an Interim Period.* When the auditor obtains evidence about the operating effectiveness of controls as of or through an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.

30. The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors:

- The inherent risk associated with the related account(s) or assertion(s);
- The specific control tested prior to year-end, including the nature of the control and the risk that the control is no longer effective during the remaining period, and the results of the tests of the control;
- The planned degree of reliance on the control;
- The sufficiency of the evidence of effectiveness obtained at an interim date;
- The length of the remaining period; and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

31. *Using Audit Evidence Obtained in Past Audits.* For audits of financial statements, the auditor should obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies. When controls have been tested in past audits, the auditor should take into account the following factors to determine the evidence needed during the current year audit to support the auditor's control risk assessments:

- The nature and materiality of misstatements that the control is intended to prevent or detect

- The inherent risk associated with the related account(s) or assertion(s)

- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness

- Whether the account has a history of errors

- The effectiveness of entity-level controls, especially controls that monitor other controls

- The nature of the controls and the frequency with which they operate

- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls)

- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance

- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective)[12/]

- The complexity of the control and the significance of the judgments that must be made in connection with its operation

- The planned degree of reliance on the control

[12/] The auditor also may use a benchmarking strategy, when appropriate, for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B28 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*.

- The nature, timing, and extent of procedures performed in past audits

- The results of the previous years' testing of the control

- Whether there have been changes in the control or the process in which it operates since the previous audit

- For integrated audits, the evidence regarding the effectiveness of the controls obtained during the audit of internal control

Assessing Control Risk

32. The auditor should assess control risk for relevant assertions by evaluating the evidence obtained from all sources, including the auditor's testing of controls for the audit of internal control and the audit of financial statements, misstatements detected during the financial statement audit, and any identified control deficiencies.

33. Control risk should be assessed at the maximum level for relevant assertions for which controls necessary to sufficiently address the assessed risk of material misstatement in those assertions are missing or ineffective or when the auditor has not obtained sufficient appropriate evidence about the effectiveness of those controls.

34. When deficiencies affecting the controls upon which the auditor intends to rely are detected, the auditor should evaluate the severity of the deficiencies and the effect on the auditor's control risk assessments. If the auditor plans to rely on controls relating to an assertion, but the controls that the auditor tests are ineffective because of control deficiencies, the auditor should:

a. Perform tests of other controls related to the same assertion as the ineffective controls; or

b. Revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased assessment of risk.

Note: Auditing Standard No. 5 provides direction on evaluating the severity of a control deficiency and communicating identified control deficiencies to management and the audit committee in an integrated audit. AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements,* provides direction on communicating significant deficiencies and material weaknesses in an audit of financial statements only.

Testing Controls in an Audit of Internal Control

35. Auditing Standard No. 5 states that the objective of the tests of controls in an audit of internal control is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a point in time and taken as a whole.[13/] Auditing Standard No. 5 establishes requirements regarding the selection of controls to be tested and the necessary nature, timing, and extent of tests of controls in an audit of internal control over financial reporting.

Substantive Procedures

36. The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.

37. As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures. Further, for an individual assertion, different combinations of the nature, timing, and extent of testing might provide sufficient appropriate evidence to respond to the assessed risk of material misstatement.

[13/] Paragraph B1 of Auditing Standard No. 5.

38. Internal control over financial reporting has inherent limitations,[14/] which, in turn, can affect the evidence that is needed from substantive procedures. For example, more evidence from substantive procedures ordinarily is needed for relevant assertions that have a higher susceptibility to management override or to lapses in judgment or breakdowns resulting from human failures.[15/]

Nature of Substantive Procedures

39. Substantive procedures generally provide persuasive evidence when they are designed and performed to obtain evidence that is relevant and reliable. Also, some types of substantive procedures, by their nature, produce more persuasive evidence than others. Inquiry alone does not provide sufficient appropriate evidence to support a conclusion about a relevant assertion.

> Note: Proposed Auditing Standard, *Audit Evidence,* provides more direction regarding the types of substantive procedures and the relevance and reliability of audit evidence.

40. Taking into account the types of potential misstatements in the relevant assertions that could result from the identified risks, as required by paragraph 9(b), can help the auditor determine the types and combination of substantive audit procedures that are necessary to detect material misstatements in the respective assertions.

41. *Substantive Procedures Related to the Period-end Financial Reporting Process.* The auditor's substantive procedures must include the following audit procedures related to the period-end financial reporting process:

a. Reconciling the financial statements with the underlying accounting records; and

b. Examining material adjustments made during the course of preparing the financial statements.

14/ Paragraph A5 of Auditing Standard No. 5.

15/ See, e.g., paragraph .14 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures.*

Note: AU secs. 316.58-.62 provide direction on examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.

Extent of Substantive Procedures

42. The more extensively a substantive procedure is performed, the greater the evidence obtained from the procedure. The necessary extent of a substantive audit procedure depends on the materiality of the account or disclosure, the assessed risk of material misstatement, and the necessary degree of assurance from the procedure. However, increasing the extent of an audit procedure cannot adequately address an assessed risk of material misstatement unless the evidence to be obtained from the procedure is reliable and relevant.

Timing of Substantive Procedures

43. Performing certain substantive procedures at interim dates may permit early consideration of matters affecting the year-end financial statements, e.g., testing material transactions involving higher risks of misstatement. However, performing substantive procedures at an interim date without performing procedures at a later date increases the risk that a material misstatement could exist in the year-end financial statements that would not be detected by the auditor. This risk increases as the period between the interim date and year end increases.

44. In determining whether it is appropriate to perform substantive procedures at an interim date, the auditor should take into account the following:

a. The assessed risk of material misstatement, including:

(1) The auditor's assessment of control risk (as discussed in paragraphs 32-34)

(2) The existence of conditions or circumstances, if any, that create incentives or pressures on management to misstate the financial statements between the interim test date and the end of the period covered by the financial statements

b. The nature of the substantive procedures

c. The nature of the account or disclosure and relevant assertion

d. The ability of the auditor to perform the necessary audit procedures to cover the remaining period

45. When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. Such procedures should include (a) comparing relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual and investigating such amounts, and (b) performing audit procedures to test the remaining period.

46. If the auditor obtains evidence that contradicts the evidence on which the original risk assessments were based, including evidence of misstatements that he or she did not expect, the auditor should re-evaluate the related risk assessments and modify the planned nature, timing, or extent of substantive procedures covering the remaining period as necessary. Examples of such modifications include extending or repeating at the period end the procedures performed at the interim date.

Dual-purpose Tests

47. In some situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction (a "**dual-purpose test**"). In those situations, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested.[16/]

[16/] Paragraph .44 of AU sec. 350, *Audit Sampling,* discusses applying audit sampling in dual-purpose tests.

APPENDIX A– Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Dual-purpose test – Substantive test of a transaction and a test of a control relevant to that transaction that are performed concurrently, e.g., a substantive test of sales transactions performed concurrently with a test of controls over those transactions.

A3. Period of reliance – The period being covered by the company's financial statements, or the portion of that period, for which the auditor plans to rely on controls in order to modify the nature, timing, and extent of planned substantive procedures.

Proposed Auditing Standard

Evaluating Audit Results

Introduction

1. This standard establishes requirements and provides direction regarding the auditor's evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.

Objective

2. The objective of the auditor is to evaluate the results of the audit to determine whether the audit evidence obtained is sufficient and appropriate to support the opinion to be expressed in the auditor's report.

Evaluating the Results of the Audit of Financial Statements

3. In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, the auditor should take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.

4. In the audit of the financial statements,[1/] the auditor's evaluation of audit results should include evaluation of the following:

   a. The results of analytical procedures performed in the overall review of the financial statements ("overall review");

   b. **Misstatements** accumulated during the audit, including, in particular, **uncorrected misstatements**;[2/]

[1/] For purposes of this standard, the term "audit of the financial statements" refers to the financial statement portion of the integrated audit and to the audit of the financial statements only.

[2/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

c. The qualitative aspects of the company's accounting practices;

d. Conditions identified during the audit that relate to the assessment of the risk of material misstatement due to fraud ("fraud risk");

e. The presentation of the financial statements, including disclosures; and

f. The sufficiency and appropriateness of the audit evidence obtained.

Performing Analytical Procedures in the Overall Review

5. In the overall review, the auditor should read the financial statements and disclosures and perform analytical procedures to (a) assess the auditor's conclusions formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement.

6. As part of the overall review, the auditor should evaluate whether –

a. The evidence gathered in response to unusual or unexpected transactions, events, amounts or relationships previously identified during the audit is sufficient, and

b. Unusual or unexpected transactions, events, amounts or relationships[3/] indicate risks of material misstatement that were not identified previously, including, in particular, fraud risks.

> Note: If the auditor discovers a previously unidentified risk of material misstatement or concludes that the evidence gathered is not adequate, he or she should modify his or her audit procedures or perform additional procedures as necessary in accordance with paragraph 36.

[3/] Paragraph 45 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement.*

7. The nature and extent of the analytical procedures performed during the overall review may be similar to the analytical procedures performed as risk assessment procedures. These procedures should include analytical procedures relating to revenue through the end of the reporting period.[4/]

8. The auditor should obtain corroboration for management's explanations regarding significant unusual or unexpected transactions, events, amounts or relationships. If management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures as necessary to address the matter.

9. *Evaluating Whether Analytical Procedures Indicate a Previously Unrecognized Fraud Risk.* Whether an unusual or unexpected transaction, event, amount, or relationship indicates a fraud risk as discussed in paragraph 6b depends on the relevant facts and circumstances, including the nature of the account or relationship among the data used in the analytical procedures. For example, certain unusual or unexpected transactions, events, amounts or relationships could indicate a fraud risk if a component of the relationship involves accounts and disclosures that management has incentives or pressures to manipulate, e.g., significant unusual or unexpected relationships involving year-end revenue and income.

Accumulating and Evaluating Identified Misstatements

10. *Accumulating Identified Misstatements.* The auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial.[5/]

[4/] Paragraphs 43-45 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* provide direction on performing analytical procedures relating to revenue as part of the risk assessment procedures.

[5/] Clearly trivial is not another expression for not material. Matters that are clearly trivial will be of a smaller order of magnitude than materiality determined in accordance with Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*, and will be inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be trivial.

11. The auditor may designate an amount below which misstatements are clearly trivial and do not need to be accumulated. In such cases, the amount should be set so that any misstatements below that amount would not be material to the financial statements, individually or in combination with other misstatements, considering the possibility of undetected misstatement.

12. The auditor's accumulation of misstatements should include the auditor's best estimate of the total misstatement in the accounts and disclosures that he or she has tested, not just the amount of misstatements specifically identified. This includes misstatements related to accounting estimates, as determined in accordance with paragraph 13, and projected misstatements from substantive procedures that involve audit sampling, as determined in accordance with paragraph .26 of AU sec. 350, *Audit Sampling.*

13. *Misstatements Relating to Accounting Estimates.* If the auditor concludes that the amount of an accounting estimate included in the financial statements is unreasonable or was not determined in conformity with the applicable accounting principles, he or she should treat the difference between that estimate and a reasonable estimate determined in conformity with the applicable accounting principles as a misstatement. If a range of reasonable estimates is supported by sufficient appropriate audit evidence, and the recorded estimate is outside of the range of reasonable estimates, the auditor should treat the difference between the recorded accounting estimate and the closest reasonable estimate as a misstatement.[6/]

> Note: Paragraph 27 discusses evaluating accounting estimates for bias.

14. *Considerations as the Audit Progresses.* The auditor should determine whether the overall audit strategy and audit plan need to be revised if:

a. The nature of accumulated misstatements and the circumstances of their occurrence indicate that other misstatements might exist

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[6/] If an accounting estimate is determined in conformity with the applicable accounting principles and the amount of the estimate is reasonable, a difference between an estimated amount best supported by the audit evidence and the recorded amount of the accounting estimate ordinarily would not be considered to be a misstatement. See paragraph 27.

that, in combination with accumulated misstatements, could be material; or

b. The aggregate of misstatements accumulated during the audit approaches the materiality level used in planning and performing the audit.[7/]

> Note: When the aggregate of accumulated misstatements approaches the materiality level used in planning and performing the audit, there likely will be greater than an appropriately low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit that remain uncorrected, could be material to the financial statements. If the auditor's assessment of this risk is unacceptably high, he or she should perform additional audit procedures or determine that management has adjusted the financial statements so that the risk that financial statements are materially misstated has been reduced to an appropriately low level.

15. The auditor should communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them.

16. If management has examined an account or a disclosure in response to misstatements detected by the auditor and has made corrections to the account or disclosure, the auditor should evaluate management's work to determine whether the corrections have been appropriately recorded and whether uncorrected misstatements remain.

17. *Evaluation of the Effect of Uncorrected Misstatements.* The auditor should evaluate whether the uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the accounts and disclosures

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[7/] Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit.*

and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.[8/]

> Note: As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility[9/] that it could lead to a material contingent liability or a material loss of revenue.[10/] Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

> Note: If the reassessment of materiality as set forth in paragraphs 11-12 of Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit,* results in a lower amount for the materiality level, the auditor should take into account that lower materiality level in the evaluation of uncorrected misstatements.

18. The auditor's evaluation of uncorrected misstatements, as described in the preceding paragraph, should include evaluation of the effects of uncorrected misstatements detected in prior years and misstatements detected in the current year that relate to prior years.

19. The auditor cannot assume that an instance of error or fraud is an isolated occurrence. Therefore, the auditor should evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement. This evaluation is important in determining whether the

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[8/] If the financial statements contain material misstatements, AU sec. 508, *Reports on Audited Financial Statements*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 provides direction when the financial statements are materially affected by a departure from the applicable financial reporting framework.

[9/] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

[10/] AU sec. 317, *Illegal Acts by Clients.*

risk assessments remain appropriate, as discussed in paragraph 36 of this standard.

20. *Evaluating Whether Misstatements Might Be Indicative of Fraud.* The auditor should evaluate whether identified misstatements[11/] might be indicative of fraud and, in turn, how they affect the auditor's evaluation of materiality and the related audit responses. As indicated in paragraph .05 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, fraud is an intentional act that results in material misstatement of the financial statements.

21. If the auditor believes that a misstatement is or might be intentional and if the effect on the financial statements could be material or cannot be readily determined, the auditor should attempt to obtain additional audit evidence to determine whether fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements and the auditor's report thereon.

22. Also, for any misstatements that the auditor believes are or might be intentional, the auditor should assess the implications for the integrity of management or employees and the possible effect on other aspects of the audit. If the misstatement involves higher-level management, it might be indicative of a more pervasive problem, such as an issue with the integrity of management, even if the amount of the misstatement is small. In such circumstances, the auditor should reevaluate the assessment of fraud risk and the effect of that assessment on (a) the nature, timing, and extent of the necessary tests of accounts or disclosures, and (b) the assessment of the effectiveness of controls. The auditor also should evaluate whether the circumstances or conditions indicate possible collusion involving employees, management, or external parties and, if so, the effect of the collusion on the reliability of evidence obtained.

23. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, he or she also must determine his or her responsibilities under AU secs. 316.79-.82A, AU sec. 317, *Illegal Acts by Clients,* and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1.

[11/] Misstatements include omission or incomplete presentation of disclosures.

Evaluating the Qualitative Aspects of the Company's Accounting Practices

24. When evaluating whether the financial statements as a whole are free of material misstatement, the auditor should evaluate the qualitative aspects of the company's accounting practices, including potential bias in management's judgments about the amounts and disclosures in the financial statements.

25. The following are examples of forms of management bias:

a. The selective correction of misstatements brought to management's attention during the audit (e.g., correcting misstatements with the effect of increasing reported earnings but not correcting misstatements that have the effect of decreasing reported earnings).

> Note: To assess the potential effect of selective correction of misstatements, the auditor should obtain an understanding of the reasons why management decided not to correct misstatements communicated by the auditor in accordance with paragraph 15.

b. The identification by management of additional adjusting entries that offset other misstatements identified by the auditor. If such misstatements are identified, the auditor should perform procedures to determine why the misstatement was not identified previously and assess the implications on the integrity of management and the auditor's risk assessments, including fraud risk assessments, and should perform additional procedures as necessary to address the risk of further undetected misstatements.

c. Bias in the selection and application of accounting principles.[12/]

d. Bias in accounting estimates.[13/]

26. If the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, he or she should evaluate

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[12/] Paragraph 5.d. of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

[13/] Paragraph 27.

whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. Also, the auditor should evaluate whether the auditor's risk assessments, including, in particular, the assessment of the risks of material misstatement due to fraud, and the related audit responses remain appropriate.

27. *Evaluating Bias in Accounting Estimates.* The auditor should evaluate whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the company's management. If each accounting estimate included in the financial statements was individually reasonable but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income, the auditor should evaluate whether this indicates potential management bias in the estimates. Bias can also result from the cumulative effect of changes in multiple accounting estimates.

> Note: AU secs. 316.64-.65 provide additional direction regarding performing a retrospective review of accounting estimates and evaluating the potential for fraud risks.

Evaluating Conditions Relating to the Assessment of Fraud Risks

28. When evaluating the results of the audit, the auditor should evaluate whether the accumulated results of auditing procedures[14/] and other observations affect the assessment of the fraud risks made throughout the audit and the need to modify the audit procedures to respond to those risks. (See Appendix C.)

29. As part of this evaluation, the engagement partner should ascertain whether there has been appropriate communication with the other engagement team members throughout the audit regarding information or conditions indicative of fraud risks.[15/]

[14/] Such auditing procedures include, but are not limited to, procedures in the overall review (paragraph 9), the evaluation of identified misstatements (paragraphs 20-23), and the evaluation of the qualitative aspects of the company's accounting practices (paragraphs 24-27).

[15/] To accomplish this communication, the engagement partner might arrange another discussion among the audit team members about fraud risks.

Evaluating the Presentation of the Financial Statements, Including the Disclosures

30. The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.[16/]

> Note: AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles,* establish requirements for evaluating the presentation of the financial statements. Auditing Standard No. 6, *Evaluating Consistency of Financial Statements,* provides direction on evaluating the consistency of the accounting principles used in financial statements.

31. As part of the evaluation of the presentation of the financial statements, the auditor should evaluate whether the financial statements contain the required disclosures. Evaluation of disclosures includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

> Note: According to AU sec. 508, *Reports on Audited Financial Statements,* if the financial statements, including accompanying notes, fail to disclose information that is required by the applicable financial reporting framework, the auditor should express a qualified or adverse opinion and should provide the information in the report, if practicable, unless its omission from the report is recognized as appropriate by a specific auditing standard.[17/]

(See paragraphs 47-48 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement.*)

[16/] The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

[17/] See AU secs. 508.41-.44.

Evaluating the Sufficiency and Appropriateness of Audit Evidence

32. Paragraph 3 of Proposed Auditing Standard, *Audit Risk,* states:

> To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.

33. As part of evaluating audit results, the auditor must conclude on whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements.

34. Factors that are relevant to the conclusion on whether sufficient appropriate audit evidence has been obtained include the following:

a. Significance of uncorrected misstatements and the likelihood of their having a material effect, individually or in combination, on the financial statements, considering the possibility of further undetected misstatement. (See paragraphs 14 and 17-19.)

b. The results of audit procedures performed in the audit of the financial statements, including whether such audit procedures identified specific instances of fraud, as discussed in paragraphs 20-23 and 28-29.

c. The auditor's risk assessments. (See paragraph 36.)

d. The results of audit procedures performed in the audit of internal control over financial reporting, if the audit is an integrated audit.

e. The relevance and reliability of the audit evidence obtained.[18/]

[18/] Paragraphs 7-9 of Proposed Auditing Standard, *Audit Evidence,* discuss the relevance and reliability of audit evidence.

35. If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion or has substantial doubt about a relevant assertion, the auditor should attempt to obtain further audit evidence to address the matter. If the auditor is unable to obtain sufficient appropriate audit evidence to have a reasonable basis to conclude about whether the financial statements as a whole are free of material misstatement, AU sec. 508 indicates that the auditor should express a qualified opinion or a disclaimer of opinion.[19/]

36. *Evaluating the Appropriateness of Risk Assessments.* As part of the evaluation of whether sufficient appropriate audit evidence has been obtained, the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate and whether the audit procedures need to be modified or additional procedures need to be performed as a result of any changes in the risk assessments. For example, the reevaluation of the auditor's risk assessments could result in the identification of relevant assertions or significant risks that were not identified previously and for which the auditor should perform additional audit procedures.

> Note: Paragraph 74 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* provides further direction on revising the auditor's risk assessment. Paragraphs 32-34 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement,* discuss the auditor's responsibilities regarding the assessment of control risk and evaluation of control deficiencies in an audit of financial statements.

Evaluating the Results of the Audit of Internal Control Over Financial Reporting

37. Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements,* indicates that the auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls for the audit of internal control over financial reporting and the financial statement audit, misstatements detected during the financial statement audit, and any identified control deficiencies. Auditing Standard No. 5

[19/] AU sec. 508.22-.34, provide direction on audit scope limitations.

describes the auditor's responsibilities regarding evaluating the results of the audit, including evaluating the identified control deficiencies.[20/]

[20/] Paragraphs 62-70 of Auditing Standard No. 5 discuss evaluating identified control deficiencies and paragraphs 71-73 of Auditing Standard No. 5 discuss forming an opinion on the effectiveness of internal control over financial reporting.

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Misstatement – A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework.[21/] A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework. Misstatements can arise from error (i.e., unintentional misstatement) or fraud.[22/]

A3. Uncorrected misstatements – Misstatements accumulated during the audit that management has not corrected.

[21/] The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

[22/] See AU sec. 316.02.

APPENDIX B – Qualitative Factors Related to the Evaluation of the Materiality of Uncorrected Misstatements

B1. Paragraph 17 states –

> The auditor should evaluate whether the uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the accounts and disclosures and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.[23/]
>
> > Note: As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility[24/] that it could lead to a material contingent liability or a material loss of revenue.[25/] Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

B2. Qualitative factors to consider in the auditor's evaluation of the materiality of uncorrected misstatements, if relevant, include the following:

23/ If the financial statements contain material misstatements, AU sec. 508, *Reports on Audited Financial Statements*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 provides direction when the financial statements are materially affected by a departure from the applicable financial reporting framework.

24/ There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

25/ See AU sec. 317, *Illegal Acts by Clients.*

a. The potential effect of the misstatement on trends, especially trends in profitability.

b. A misstatement that changes a loss into income or vice versa.

c. The effect of the misstatement on segment information, for example, the significance of the matter to a particular segment important to the future profitability of the company, the pervasiveness of the matter on the segment information, and the impact of the matter on trends in segment information, all in relation to the financial statements taken as a whole.

d. The potential effect of the misstatement on the company's compliance with loan covenants, other contractual agreements, and regulatory provisions.

e. The existence of statutory or regulatory reporting requirements that affect materiality thresholds.

f. A misstatement that has the effect of increasing management's compensation, for example, by satisfying the requirements for the award of bonuses or other forms of incentive compensation.

g. The sensitivity of the circumstances surrounding the misstatement, for example, the implications of misstatements involving fraud and possible illegal acts, violations of contractual provisions, and conflicts of interest.

h. The significance of the financial statement element affected by the misstatement, for example, a misstatement affecting recurring earnings as contrasted to one involving a non-recurring charge or credit, such as an extraordinary item.

i. The effects of misclassifications, for example, misclassification between operating and non-operating income or recurring and non-recurring income items.

j. The significance of the misstatement or disclosures relative to known user needs, for example −

- The significance of earnings and earnings per share to public company investors,

- The magnifying effects of a misstatement on the calculation of purchase price in a transfer of interests (buy/sell agreement).

- The effect of misstatements of earnings when contrasted with expectations.

k. The definitive character of the misstatement, for example, the precision of an error that is objectively determinable as contrasted with a misstatement that unavoidably involves a degree of subjectivity through estimation, allocation, or uncertainty.

l. The motivation of management with respect to the misstatement, for example, (i) an indication of a possible pattern of bias by management when developing and accumulating accounting estimates or (ii) a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process.

m. The existence of offsetting effects of individually significant but different misstatements.

n. The likelihood that a misstatement that is currently immaterial may have a material effect in future periods because of a cumulative effect, for example, that builds over several periods.

o. The cost of making the correction − it may not be cost-beneficial for the client to develop a system to calculate a basis to record the effect of an immaterial misstatement. On the other hand, if management appears to have developed a system to calculate an amount that represents an immaterial misstatement, it may reflect a motivation of management as noted in paragraph B2.l above.

p. The risk that possible additional undetected misstatements would affect the auditor's evaluation.

APPENDIX C – Matters That Might Affect the Assessment of Fraud Risks

C1. If the following matters are identified during the audit, the auditor should determine whether the assessment of fraud risks remains appropriate or needs to be revised:

a. Discrepancies in the accounting records, including:

(1) Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or company policy

(2) Unsupported or unauthorized balances or transactions

(3) Last-minute adjustments that significantly affect financial results

(4) Evidence of employees' access to systems and records that is inconsistent with the access that is necessary to perform their authorized duties

(5) Tips or complaints to the auditor about alleged fraud

b. Conflicting or missing evidence, including:

(1) Missing documents

(2) Documents that appear to have been altered[26/]

(3) Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist

(4) Significant unexplained items on reconciliations

26/ Paragraph 9 of Proposed Auditing Standard, *Audit Evidence.*

(5) Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures

(6) Unusual discrepancies between the company's records and confirmation replies

(7) Missing inventory or physical assets of significant magnitude

(8) Unavailable or missing electronic evidence, that is inconsistent with the company's record retention practices or policies

(9) Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments

(10) Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships – for example, receivables growing faster than revenues

(11) Large numbers of credit entries and other adjustments made to accounts receivable records

(12) Unexplained or inadequately explained differences between the accounts receivable subsidiary ledger and the general ledger control account, or between the customer statement and the accounts receivable subsidiary ledger

(13) Missing or non-existent cancelled checks in circumstances in which cancelled checks are ordinarily returned to the company with the bank statement

(14) Fewer responses to confirmation requests than anticipated or a greater number of responses than anticipated

c. Problematic or unusual relationships between the auditor and management, including:

(1) Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought, including:[27]

a. Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques

b. Denial of access to key IT operations staff and facilities, including security, operations, and systems development

(2) Undue time pressures imposed by management to resolve complex or contentious issues

(3) Management pressuring engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management

(4) Unusual delays by management in providing requested information

(5) An unwillingness to add or revise disclosures in the financial statements to make them more complete and transparent

(6) An unwillingness to appropriately address significant deficiencies in internal control on a timely basis

d. Other:

(1) Objections by management to the auditor meeting privately with the audit committee

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[27] Denial of access to information might constitute a limitation on the scope of the audit that requires the auditor to qualify or disclaim an opinion. (See Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and AU sec. 508, *Reports on Audited Financial Statements.*)

(2) Accounting policies that appear inconsistent with industry practices that are widely recognized and prevalent

(3) Frequent changes in accounting estimates that do not appear to result from changing circumstances

(4) Tolerating violations of the company's code of conduct

Proposed Auditing Standard

Audit Evidence

Introduction

1. This standard explains what constitutes audit evidence, establishes requirements and provides direction regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.

2. Audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the audit opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and any information that contradicts such assertions.

Objective

3. The objective of the auditor is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report.

> Note: Proposed Auditing Standard, *Evaluating Audit Results,* establishes requirements and provides direction regarding evaluating whether sufficient appropriate evidence has been obtained. Auditing Standard No. 3, *Audit Documentation,* establishes requirements and provides direction regarding documenting the procedures performed, evidence obtained, and conclusions reached in an audit.

Sufficient Appropriate Audit Evidence

4. The auditor must design and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion.

5. Sufficiency is the measure of the *quantity* of audit evidence. The quantity of audit evidence needed is affected by the following:

- *Risk of material misstatement (in the audit of financial statements) or the risk associated with the control (in the audit of internal control over financial reporting).* As the risk increases, the amount of evidence that the auditor should obtain also increases. For example, ordinarily more evidence is needed to respond to significant risks.

- *Quality of the audit evidence obtained.* As the quality of the evidence increases, the need for additional corroborating evidence decreases. Obtaining more of the same type of audit evidence, however, cannot compensate for the poor quality of that evidence.

6. Appropriateness is the measure of the quality of audit evidence, i.e., its relevance and reliability. To be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based. Relevance and reliability are discussed in the following paragraphs.

Relevance and Reliability

7. *Relevance.* The relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The relevance of audit evidence depends on:

a. The design of the audit procedure used to test the assertion or control, in particular whether it is designed to (1) test the assertion or control directly and (2) test for understatement or overstatement; and

b. The timing of the audit procedure used to test the assertion or control.

8. *Reliability.* The reliability of evidence depends on the nature and source of the evidence and the circumstances under which it is obtained. For example, in general:

- Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources

- The reliability of information generated internally by the company is increased when the company's controls over that information are effective

- Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly

- Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise converted into electronic form, the reliability of which depends on the controls over the conversion and maintenance of those documents

9. The auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should determine the effect, if any, on the other aspects of the audit.

Using Information Produced by the Company

10. When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit, by performing procedures to:[1/]

- Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information
- Evaluate whether the information is sufficiently precise and detailed for purposes of the audit

Financial Statement Assertions

11. In representing that the financial statements are presented fairly in conformity with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures. Those assertions can be classified into the following categories:

- *Existence or occurrence* – Assets or liabilities of the company exist at a given date, and recorded transactions have occurred during a given period.

[1/] When using the work of a specialist engaged by management, see AU sec. 336, *Using the Work of a Specialist.* When using information produced by a service organization or a service auditor's report as audit evidence, see AU sec. 324, *Service Organizations*, and for integrated audits, Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

- *Completeness* – All transactions and accounts that should be presented in the financial statements are so included.

- *Valuation or allocation* – Asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts.

- *Rights and obligations* – The company holds or controls rights to the assets, and liabilities are obligations of the company at a given date.

- *Presentation and disclosure* – The components of the financial statements are properly classified, described, and disclosed.

12. The auditor may base his or her work on assertions that differ from those in this standard if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement in each significant account and disclosure that have a reasonable possibility[2/] of containing misstatements that would cause the financial statements to be materially misstated.[3/]

Audit Procedures for Obtaining Audit Evidence

13. Audit procedures can be classified into the following categories:

a. Risk assessment procedures[4/] and

b. Further audit procedures,[5/] which consist of:

(1) Tests of controls and

[2/] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

[3/] For an integrated audit, also see paragraph 28 of Auditing Standard No. 5.

[4/] Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement.*

[5/] Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement.*

(2) Substantive procedures, including tests of details and substantive analytical procedures

14. Paragraphs 15-21 of this standard describe specific audit procedures. The purpose of an audit procedure determines whether it is a risk assessment procedure, test of controls, or substantive procedure.

Inspection

15. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or physically examining an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorization.

Observation

16. Observation consists of looking at a process or procedure being performed by others, e.g., the auditor's observation of inventory counting by the company's personnel, or of the performance of control activities. Observation can provide audit evidence about the performance of a process or procedure, but the evidence is limited to the point in time at which the observation takes place, and also is limited by the fact that the act of being observed may affect how the process or procedure is performed.

Note: AU sec. 331, *Inventories,* establishes requirements and provides direction regarding observation of the counting of inventory.

Inquiry

17. Inquiry consists of seeking information from knowledgeable persons in financial or nonfinancial roles within the company or outside the company. Inquiry may be performed throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Note: Inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.

Note: AU sec. 333, *Management Representations,* establishes requirements and provides direction regarding written management representations, including confirmation of management responses to oral inquiries.

Confirmation

18. A confirmation represents audit evidence obtained by the auditor as a direct response to the auditor from a third party. Confirmation procedures frequently are used in relation to account balances and their constituent parts, e.g., confirmation of receivables by communication with debtors. However, confirmations need not be restricted to these items. For example, if the auditor requests confirmation of the terms of a company's agreements or transactions with third parties, the confirmation request may be designed to ask if any modifications have been made to the agreement or if side agreements exist and, if so, what the relevant details are.

Note: AU sec. 330, *The Confirmation Process,* establishes requirements and provides direction regarding confirmations.

Recalculation

19. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Re-performance

20. Re-performance involves the independent execution of procedures or controls that were originally performed by company personnel.

Analytical Procedures

21. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of significant differences from expected amounts.

Note: AU sec. 329, *Substantive Analytical Procedures,* establishes requirements and provides direction on performing analytical procedures as substantive procedures.

Selecting Items for Testing to Obtain Audit Evidence

22. Designing substantive tests of details and tests of controls includes determining the means of selecting items for testing from among the items included in an account or based on the occurrences of a control. The auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. The alternative means of selecting items for testing are:

- Selecting all items
- Selecting specific items
- Audit sampling

23. The particular means or combination of means of selecting items for testing that is appropriate depends on the nature of the audit procedure, the characteristics of the control or the items comprising the account being tested, and the evidence necessary to meet the objective of the audit procedure.

Selecting All Items

24. Selecting all items (100 percent examination) refers to testing the entire population of the occurrences of a control or items that comprise an account (or a stratum within that population). The following are examples of situations in which 100 percent examination might be applied:

- The population constitutes a small number of large value items;
- The audit procedure is designed to respond to a significant risk and other means of selecting items for testing do not provide sufficient appropriate audit evidence; or
- The audit procedure can be automated effectively and applied to the entire population.

Selecting Specific Items

25. Selecting specific items refers to testing all of the items in a population that have a specified characteristic, such as:

- *Key items.* The auditor may decide to select specific items within a population because they are important to accomplishing the objective of the audit procedure or exhibit some other characteristic, e.g., items that are suspicious, unusual, particularly risk-prone or that have a history of error.

- *All items over a certain amount.* The auditor may decide to examine items whose recorded values exceed a certain amount to verify a large proportion of the total amount of the items included in an account.

26. The auditor also might select specific items to obtain an understanding about matters such as the nature of the company or the nature of transactions.

27. The application of audit procedures to items that are selected as described in paragraphs 24 and 25 does not constitute audit sampling, and the results of those audit procedures cannot be projected to the entire population.[6/]

Audit Sampling

28. Audit sampling is the application of an audit procedure to less than 100 percent of the occurrences of a control or items comprising an account for the purpose of evaluating some characteristic of the control or account.

> Note: AU sec. 350, *Audit Sampling,* establishes requirements and provides direction regarding audit sampling.

Inconsistency in, or Doubts about the Reliability of, Audit Evidence

29. If audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

[6/] If misstatements are identified in the selected items, see paragraphs 12-13 and paragraphs 17-19 of Proposed Auditing Standard, *Evaluating Audit Results.*

APPENDIX 8

Proposed Amendments to PCAOB Standards

Auditing Standards

AU sec. 110, "Responsibilities and Functions of the Independent Auditor"

Statement on Auditing Standard ("SAS") No. 1, "Codification of Auditing Standards and Procedures" section 110, "Responsibilities and Functions of the Independent Auditor" (AU sec. 110, "Responsibilities and Functions of the Independent Auditor") is amended as follows –

> Within footnote 1 to paragraph .02, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit.*

AU sec. 150, "Generally Accepted Auditing Standards"

SAS No. 95, "Generally Accepted Auditing Standards" (AU sec. 150, "Generally Accepted Auditing Standards"), as amended, is amended as follows –

a. Within paragraph .02, in the third standard of field work, the word "competent" is replaced with the word "appropriate."

b. Footnote 2 to paragraph .04 is deleted.

AU sec. 210, "Training and Proficiency of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 210, "Training and Proficiency of the Independent Auditor" (AU sec. 210, "Training and Proficiency of the Independent Auditor ") is amended as follows –

The last sentence of paragraph .03 is replaced with –

> The engagement partner must exercise a seasoned judgment in the varying degrees of his supervision and review of the work done and judgment exercised by his subordinates, who in turn must meet the responsibility attaching to the varying gradations and functions of their work.

AU sec. 230, "Due Professional Care in the Performance of Work"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 230, "Due Professional Care in the Performance of Work" (AU sec. 230, "Due Professional Care in the Performance of Work"), as amended, is amended as follows –

a. The second and third sentences of paragraph .06 are replaced with –

   The engagement partner should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client. The engagement partner is responsible for the assignment of tasks to, and supervision of, the members of the engagement team.[fn4]

b. Footnote 3 to paragraph .06 is deleted.

c. Within footnote 4 to paragraph .06, the phrase "See section 311.11" is replaced with, "See paragraphs 22-24 of Proposed Auditing Standard, *Audit Planning and Supervision*."

d. Footnote 6 to paragraph 11 is deleted.

e. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

f. At the end of the fifth sentence of paragraph .12, the following parenthetical is added: "(See paragraph 9 of Proposed Auditing Standard, *Audit Evidence*.)"

AU sec. 310, "Appointment of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 310, "Appointment of the Independent Auditor" (AU sec. 310, "Appointment of the Independent Auditor"), as amended, is amended as follows –

a. Within footnote ** to the title of the standard, the sentence referring to section 313, which is in parentheses, is deleted.

b. In paragraph .02:

   - The word "assistants" is replaced with the term "engagement team members."

- The first reference to AU section 311, *Planning and Supervision,* is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision.*

- The second reference to AU section 311 is replaced with a reference to Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement.*

c. In paragraph .02, the reference to AU section 313, *Substantive Tests Prior to the Balance-Sheet Date,* is deleted.

d. In paragraph .03, the sentence referring to section 313, which is in parentheses, is deleted.

e. Within footnote 3 to paragraph .06, the reference to paragraph .04 of section 312, *Audit Risk and Materiality in Conducting an Audit,* is replaced with a reference to paragraph A2 of Proposed Auditing Standard, *Evaluating Audit Results.*

<u>AU sec. 311, "Planning and Supervision"</u>

SAS No. 22, "Planning and Supervision" (AU sec. 311, "Planning and Supervision"), as amended, is superseded.

<u>AU sec. 9311, "Planning and Supervision: Auditing Interpretations of Section 311"</u>

AU sec. 9311, "Planning and Supervision: Auditing Interpretation of Section 311" is superseded.

<u>AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"</u>

SAS No. 47, "Audit Risk and Materiality in Conducting an Audit" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), as amended, is superseded.

<u>AU sec. 9312, "Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312"</u>

AU sec. 9312, "Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312" is superseded.

AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"

SAS No. 45, "Omnibus Statement on Auditing Standards – 1983" (AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"), as amended, is superseded.

AU sec. 315, "Communications Between Predecessor and Successor Auditors"

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows –

a. In the first sentence of paragraph .12, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .18, the word "competent" is replaced with the word "appropriate."

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows –

a. The second sentence of paragraph .01 is replaced with –

   This section establishes requirements and provides direction relevant to fulfilling that responsibility, as it relates to fraud, in an audit of financial statements. [fn 2/]

b. In footnote 1 to paragraph .01, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is deleted.

c. Footnote 2 to paragraph .01 is replaced with –

   For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of the financial statements only.

d. The following paragraph .01A is added–

   Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* establishes requirements and provides direction regarding the process of identifying and assessing risks of material misstatement of the financial statements. Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement,* establishes requirements and provides direction regarding designing and implementing appropriate responses to the risks of material misstatement. Proposed Auditing Standard, *Evaluating Audit Results,* establishes requirements and provides direction regarding the auditor's evaluation of audit results of whether he or she has obtained sufficient appropriate audit evidence.

e. In paragraph .02:

- The third through the sixth bullet points are deleted.

- The seventh bullet point is replaced with –

  "*Responding to fraud risks.* This section discusses certain responses to fraud risks involving the nature, timing, and extent of audit procedures, including:

    o Responses to assessed fraud risks relating to fraudulent financial reporting and misappropriation of assets (see paragraph .52 through .56).

    o Responses to specifically address the fraud risks arising from management override of internal controls (see paragraphs .57 through .67)."

- The eighth bullet point is deleted.

f. Paragraph .03 is deleted.

g. Footnote 5 to paragraph .06 is replaced with –

The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

h. Paragraph .13, third sentence, the term "the risk of material misstatement due to fraud" is replaced with the term "fraud risks".

i. Paragraphs .14 through .45 are deleted, along with the preceding heading, "Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud".

j. Footnotes 8 through 19, related to paragraphs .14 through .45, are deleted.

k. Paragraphs .46 through .50 are deleted. The heading preceding paragraph .46 is replaced with the heading, "Responding to Assessed Fraud Risks."

l. Paragraph .51 is deleted. The heading preceding paragraph .51 is replaced with the heading, "Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed."

m. Paragraph .52 is replaced with –

Paragraph 8 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement,* states that "the auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement due to error or fraud for each relevant assertion of each significant account and disclosure." Paragraph 12 of that Proposed Standard states that "the audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected."

> Note: Paragraph 71.a. of Proposed Auditing Standard, *Identifying and Assessing the Risks of Material Misstatement*, indicates that a fraud risk is a significant risk. Accordingly, the requirement for responding to significant risks also applies to fraud risks.

n. In paragraph .53:

- The first sentence is replaced with –

  The following are examples of responses to assessed fraud risks involving the nature, timing, and extent of audit procedures:

- The fifth bullet point is replaced with –

Interviewing personnel involved in activities in areas where a fraud risk has been identified to obtain their insights about the risk and how controls address the risk (See paragraph 54 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*).

o. Footnote 20 to paragraph .53 is replaced with –

AU sec. 329, *Substantive Analytical Procedures*, establishes requirements regarding performing analytical procedures as substantive tests.

p. The heading preceding paragraph .54, "Additional Examples of Responses to Identified Risks of Misstatements Arising From Fraudulent Financial Reporting" is replaced with "Additional Examples of Audit Procedures Performed to Respond to Assessed Fraud Risks Relating to Fraudulent Financial Reporting."

q. The first sentence in paragraph .54 is replaced with –

The following are additional examples of audit procedures that might be performed in response to assessed fraud risks relating to fraudulent financial reporting:

r. In Paragraph .54 –

- In the last sentence of the first bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk".
- In the first sentence of the second bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk".
- In the first sentences of third bullet point and the accompanying paragraph to the third bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk".

s. Footnotes 21 and 22 to paragraph .54 are amended as follows –

- The text of footnote 21 is replaced with "AU sec. 330, *The Confirmation Process*, establishes requirements regarding the confirmation process in audits of financial statements."

- The text of footnote 22 is replaced with "AU sec. 336, *Using the Work of a Specialist*, establishes requirements for an auditor who uses the work of a specialist in performing an audit of financial statements."

t. The heading preceding paragraph .55, "Examples of Responses to Identified Risks of Misstatements Arising From Misappropriations of Assets" is replaced with the heading, "Examples of Audit Procedures Performed to Respond to Fraud Risks Relating to Misappropriations of Assets."

u. In the first sentence of paragraph .55, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk".

v. In paragraph .56:

- The first and second sentences are replaced with –

  The audit procedures performed in response to a fraud risk relating to misappropriation of assets usually will be directed toward certain account balances. Although some of the audit procedures noted in paragraphs .53 and .54 and in paragraphs 8 through 15 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement,* may apply in such circumstances, such as the procedures directed at inventory quantities, the scope of the work should be linked to the specific information about the misappropriation risk that has been identified.

- In the third sentence, the words "design and" are added before the words "operating effectiveness."

w. The heading preceding paragraph .57, "Responses to Further Address the Risk of Management Override of Controls," is replaced with the heading "Audit Procedures Performed to Specifically Address the Risk of Management Override of Controls."

x. The third sentence of paragraph .57 is replaced with –

Accordingly, as part of auditor's responses that address fraud risks, the procedures described in paragraphs .58 through .67 should be performed to specifically address the risk of management override of controls.

y. Footnote 23 to paragraph .58 is replaced with –

See paragraphs 28 through 32 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

z. In paragraph .61:

- In the first sentence of the first bullet point, the term "the risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- In the second bullet point, the last two sentences are replaced with the following –

  Effective controls over the preparation and posting of journal entries and adjustments may affect the extent of substantive testing necessary, provided that the auditor has tested the controls. However, even though controls might be implemented and operating effectively, the auditor's substantive procedures for testing journal entries and other adjustments should include the identification and substantive testing of specific items.

- In item (f) of the fifth bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- The last sentence of the fifth bullet point is replaced with –

  In audits of entities that have multiple locations or components, the auditor should determine whether to select journal entries from locations based on factors set forth in paragraphs 11 through 14 of Proposed Auditing Standard, *Audit Planning and Supervision*.

aa. The last sentence of paragraph .63 is replaced with –

Paragraphs 26 and 27 of Proposed Auditing Standard, *Evaluating Audit Results,* discuss the auditor's responsibilities for assessing bias in accounting estimates and the effect of bias on the financial statements.

bb. Paragraphs .68 through .78 are deleted, along with the preceding heading "Evaluating Audit Evidence."

cc. Footnotes 26 through 36, related to paragraphs .68 through .78 are deleted.

dd. In the first sentence of the paragraph .80, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk".

ee. The last sentence of paragraph .80 is replaced with –

The auditor also should evaluate whether the absence of or deficiencies in controls that address fraud risks or otherwise help prevent, deter, and detect fraud (see paragraph 20 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*) represent significant deficiencies that should be communicated to senior management and the audit committee.

ff. The first sentence of paragraph .81 is replaced with –

The auditor also should consider communicating other fraud risks, if any, identified by the auditor.

gg. In paragraph .83:

- The reference in the first bullet point to paragraphs .14 through .17 is replaced with paragraphs 46 through 50 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

- The term "risks of material misstatement due to fraud" in the first sentence of the second bullet point is replaced with the term "fraud risks." The reference in the second bullet point to paragraphs .19 through .34 is replaced with paragraphs 38 through 45, paragraphs 51 through 55, and paragraphs 72 through 73 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

- The third bullet point is replaced with –

  The fraud risks that were identified at the financial statement and assertion levels (see paragraphs 56 through 73 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*), and the linkage of those risks to the auditor's response (see paragraphs 5 through 15 of Proposed Auditing

Standard, *The Auditor's Responses to the Risks of Material Misstatement*.)

- Within the fourth bullet point, the term "risk of material misstatement due to fraud" in the first sentence is replaced with the term "fraud risk," and the reference to paragraph .41 is replaced with a reference to paragraph 69 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

- The fifth bullet point is replaced with –

  The results of the procedures performed to address the assessed fraud risks, including those to further address the risk of management override of controls (see paragraph 15 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatements.*)

- The reference in the sixth bullet point to paragraphs .68 through .73 is replaced with a reference to paragraphs 5 through 9 of Proposed Auditing Standard, *Evaluating Audit Results*.

hh. Paragraph .84 and the accompanying heading, "Effective Date," are deleted.

ii. The first sentence of paragraph .85 is replaced with –

This appendix contains examples of risk factors discussed in paragraphs 66 through 68 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

<u>AU sec. 317, "Illegal Acts by Clients"</u>

SAS No. 54, "Illegal Acts by Client" (AU sec. 317, "Illegal Acts by Clients"), as amended, is amended as follows –

a. The last sentence of paragraph .13 is replaced with –

For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

b. In paragraph .19, the word "competent" is replaced with the word "appropriate."

AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"

SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), as amended, is superseded.

AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"

SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), as amended, is amended as follows –

a. In the first sentence of paragraph .02, the word "competent" is replaced with the word "appropriate."

b. Within footnote 3 to paragraph .04, the reference to AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit,* is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

c. In the first sentence of paragraph .18, the word "competent" is replaced with the word "appropriate."

d. Within footnote 5 to paragraph .18, the reference to AU 326, *Evidential Matter*, paragraph .19c. is replaced with a reference to Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, paragraph 42.

e. Within footnote 8 to paragraph 27, the reference to AU sec. 311, *Planning and Supervision*, paragraphs .11 through .13 is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*, paragraphs 22 through 24.

AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations" (AU sec. 324, "Service Organization), as amended, is amended as follows –

a. In the first sentence of paragraph .07, the reference to section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

b. In the first sentence of paragraph .16, the reference to section 319.90 through .99, is replaced with a reference to Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, paragraph 18 and paragraphs 29 through 31.

c. In the second sentence of paragraph .23, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit,* is replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*.

<u>AU sec. 326, "Evidential Matter"</u>

SAS No. 31, "Evidential Matter" (AU sec. 326, "Evidential Matter"), as amended, is superseded.

<u>AU sec. 9326, "Evidential Matter: Auditing Interpretations of Section 326"</u>

AU sec. 9326, "Evidential Matter: Auditing Interpretations of Section 326," as amended, is amended –

a. Paragraphs .01-.05 are deleted

b. The reference in paragraph .10 to section 326, *Evidential Matter*, paragraph .25, is replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*, paragraph 35.

c. In the first and second sentences of paragraph .10, the word "competent" is replaced with the word "appropriate."

d. The last two sentences of paragraph .12 are deleted.

e. In the second sentence of paragraph .12, the word "competent" is replaced with the word "appropriate."

f. In the first sentence of paragraph .13, the word "competent" is replaced with the word "appropriate."

g. In paragraph .17, the word "competent" is replaced with the word "appropriate."

h. In the second sentence of paragraph .21, the word "competent" is replaced with the word "appropriate."

i. In the fourth sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."

j. In paragraph .23, the word "competent" is replaced with the word "appropriate."

k. Paragraphs .24-.41 are deleted.

<u>AU sec. 328, "Auditing Fair Value Measurements and Disclosures"</u>

SAS No. 101, "Auditing Fair Value Measurements and Disclosures" (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), as amended, is amended as follows –

a. In the first sentence of paragraph .03, the word "competent" is replaced with the word "appropriate."

b. The reference in paragraph .11 to Section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

c. The reference in paragraph .14 to section 319 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, paragraph A5, second note. The reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, is deleted.

d. Within paragraph .25, in the second sentence in the second bullet point and the first sentence in the third bullet point, the word "competent" is replaced with the word "appropriate."

e. In the second sentence of paragraph .32, the word "competent" is replaced with the word "appropriate."

f. In the first sentence of paragraph .42, the word "competent" is replaced with the word "appropriate."

g. In footnote 8 to paragraph 43, the reference to "section 431, *Adequacy of Disclosure in Financial Statements*" is replaced with "paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results."*

h. In the second sentence of paragraph .44, the word "competent" is replaced with the word "appropriate."

i. The reference in paragraph .47 to section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraphs .36 through 41, is replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*, paragraphs 12 through 18 and 24 through 27.

AU sec. 329, "Analytical Procedures"

SAS No. 56, "Analytical Procedures" (AU sec. 329, "Analytical Procedures"), as amended, is amended as follows –

a. The title of the standard "Analytical Procedures" is replaced with "Substantive Analytical Procedures."

b. The text of paragraph .01 is replaced with –

This section establishes requirements regarding the use of substantive analytical procedures in an audit.

> Note: Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* establishes requirements regarding performing analytical procedures as a risk assessment procedure in identifying and assessing the risks of material misstatement.
>
> Note: Proposed Auditing Standard, *Evaluating Audit Results,* establishes requirements on performing analytical procedures as part of the overall review stage of the audit.

c. Paragraph .03 is deleted.

d. The text of paragraph .04 is replaced with –

Analytical procedures are used as a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions. In some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

e. Paragraphs .06 - .08 and the accompanying heading are deleted.

f. At the end of paragraph .09, a new sentence is added –

(See paragraph 11 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement.*)

g. Within footnote 1 to paragraph .09, the reference to section 326, *Evidential Matter,* is replaced with a reference to Proposed Auditing Standard, *Audit Evidence.*

h. Footnote 2 to paragraph .20 is deleted.

i. In paragraph .21:

- In the fourth sentence, the word "likely" is deleted.
- The reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, is replaced with the reference to Proposed Auditing Standard, *Evaluating Audit Results*.

j. Footnote 3 to paragraph .21 is deleted.

k. Paragraphs .23 and .24 and the accompanying headings are deleted.

AU sec. 330, "The Confirmation Process"

SAS No. 67, "The Confirmation Process" (AU sec. 330, "The Confirmation Process"), is amended as follows –

a. The references in paragraph .02 to section 312, *Audit Risk and Materiality in Conducting an Audit*, and section 313, *Substantive Tests Prior to the Balance-Sheet Date*, are replaced with a reference to Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

b. The reference in paragraph .05 to section 312 is replaced with a reference to Proposed Auditing Standard, *Audit Risk*.

c. The second sentence of paragraph .06 is replaced with –

See proposed Auditing Standard, *Audit Evidence*, paragraph 8, which discusses reliability of audit evidence.

d. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate." The reference in the third sentence to Section 326 is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*.

e. In the first sentence of paragraph .24, the word "competence" is replaced with the word "appropriateness."

f. In the last sentence of paragraph .27, the word "competent" is replaced with the word "appropriate."

AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"

SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investment in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), as amended, is amended as follows –

a. The reference in paragraph .01 to section 326, *Evidential Matter*, paragraphs .03 – .08, is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*, paragraphs 11 and 12.

b. The reference in paragraph .06, to Section 311, *Planning and Supervision,* is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*.

c. The first and second sentences of paragraph .07 are deleted. The third sentence is replaced with –

The auditor should design and perform audit procedures regarding relevant assertions of derivatives and investments in securities that are based on and that address the risks of material misstatement in those assertions.

d. The reference in paragraph .09 to Section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

e. The reference in paragraph .11 to Section 319.47 is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* paragraphs 18 through 32.

f. The reference to section 319 in paragraph .15 is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

g. The last sentence of paragraph .35, is replaced with –

In addition, Proposed Auditing Standard, *Evaluating Auditing Results*, paragraphs 24 through 27, describes the auditor's responsibilities for assessing bias in accounting estimates.

h. In paragraph .43, subpart a., the word "competent" is replaced with the word "appropriate."

i. In paragraph .51, the last sentence is replaced with –

(<u>See</u> paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results.)*

j. In paragraph .57, subpart c., the word "competent" is replaced with the word "appropriate."

<u>AU sec. 333, "Management Representations"</u>

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows –

a. Footnote 4 to paragraph .06, is replaced with –

Proposed Auditing Standard, *Evaluating Audit Results*, indicates that a misstatement can arise from error or fraud and discusses the auditor's responsibilities for evaluating accumulated misstatements.

b. Within footnote 6 to paragraph .06, the reference to Section 312, is replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*, paragraph 11.

c. Within footnote 7 to paragraph .06, the reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, paragraphs .38 through .40, is replaced with a reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, paragraphs .79 through .82.

AU sec. 334, "Related Parties"

SAS No. 45 "Related Parties" (AU sec. 334 "Related Parties"), is amended as follows –

a. In the second sentence of paragraph .09, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate".

c. In footnote 8 to paragraph .11, the reference to "section 431, Adequacy of Disclosure in Financial Statements" is replaced with "paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results."*

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334"

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334," is amended as follows –

Within footnote 4 to paragraph .17, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Proposed Auditing Standard, *Audit Risk*.

AU sec. 336, "Using the Work of a Specialist"

SAS No. 73, "Using the Work of a Specialist" (AU sec. 336 "Using the Work of a Specialist"), is amended as follows –

a. The reference in paragraph .05 to section 311, *Planning and Supervision*, is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*.

b. In the last sentence of paragraph .06, the word "competent" is replaced with the word "appropriate."

c. In the first and last sentences of paragraph .13, the word "competent" is replaced with the word "appropriate."

AU sec. 9336 "Using the Work of a Specialist: Auditing Interpretations of Section 336"

AU sec. 9336, "Using the Work of a Specialist: Auditing Interpretations of Section 336," is amended as follows –

a. In the second sentence of paragraph .04, the word "competent" is replaced with the word "appropriate."

b. In paragraph .05, the word "competent" is replaced with the word "appropriate."

c. In the second sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

d. The penultimate sentence of paragraph .15, is replaced with –

Proposed Auditing Standard, *Audit Evidence*, paragraph 6, states, "to be appropriate, audit evidence must be both relevant and reliable."

AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"

SAS No. 59, "The Auditor's Consideration of an Entity's Ability to Continue as Going Concern" (AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"), as amended, is amended as follows –

The reference in paragraph .02, to section 326, *Evidential Matter*, is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*.

AU sec. 342, "Auditing Accounting Estimates"

SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), as amended, is amended as follows –

a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .07, the word "competent" is replaced with the word "appropriate."

c. The text of footnote 3 to paragraph .07 is replaced with –

See paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results.*

d. The reference in paragraph .08 subparagraph b.1. to section 311, *Planning and Supervision*, is replaced with Proposed Auditing Standard, *Audit Planning and Supervision*.

e. Paragraph .14, is replaced with –

Proposed Auditing Standard, *Evaluating Audit Results*, paragraphs 24 through 27, discuss the auditor's responsibilities for assessing bias and evaluating accounting estimates in relationship to the financial statements taken as a whole.

AU sec. 9342, "Auditing Accounting Estimates: Auditing Interpretations of Section 342"

AU sec. 9342, "Auditing Accounting Estimates: Auditing Interpretations of Section 342," is amended as follows –

In the second sentence of paragraph .02, the word "competent" is replaced with the word "appropriate."

AU sec. 350, "Audit Sampling"

SAS No. 39, "Audit Sampling" (AU sec. 350, "Audit Sampling"), as amended, is amended as follows –

a. Within footnote 2 to paragraph .02, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*.

b. The last sentence of paragraph .03 is replaced with –

Either approach to audit sampling can provide sufficient evidential matter when applied properly. This section applies to both nonstatistical and statistical sampling.

c. Paragraph .04 is deleted.

d. Within paragraph .06, the first sentence is deleted; in the last sentence, the word "competence" is replaced with the word "appropriateness," and the following Note is added to the paragraph:

> Note: Proposed Auditing Standard, *Audit Evidence*, discusses the appropriateness of audit evidence, and Proposed Auditing Standard, *Evaluating Audit Results,* discusses the auditor's responsibilities for evaluating the sufficiency and appropriateness of audit evidence.

e. Paragraph .08 is deleted.

f. The sentence in paragraph .09 referring to section 313, which is in parentheses, is deleted; the following note is added to paragraph .09 –

> Note: Paragraphs 5 through 10 of Proposed Auditing Standard, *Audit Risk,* describes audit risk and its components in a financial statement audit – the risk of material misstatement (consisting of inherent risk and control risk) and detection risk.

g. The reference in paragraph .11 to section 311, *Planning and Supervision*, is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*. The sentence referring to section 313, which is in parentheses, is deleted.

h. The second sentence of paragraph .15, is replaced with –

See also Proposed Auditing Standard, *Audit Planning and Supervision*.

i. The reference in the first bullet in paragraph .16 to section 326, *Evidential Matter*, is deleted. In the second bullet, the phrase "preliminary judgment about materiality" is replaced with the phrase "Tolerable misstatement. (See paragraph .18-.18A.)"

j. Paragraph .18 is replaced with –

Evaluation in monetary terms of the results of a sample for a substantive test of details contributes directly to the auditor's purpose, since such an evaluation can be related to his or her judgment of the monetary amount of misstatements that would be material. When planning a sample for a substantive test of details, the auditor should consider how much monetary misstatement in the related account balance or class of transactions may exist, in combination with other misstatements, without causing the financial statements to be materially misstated. This maximum monetary misstatement for the balance or class is called *tolerable misstatement*.

k. Paragraph .18A is added –

Paragraphs 8 - 9 of Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*, describe the auditor's responsibilities for determining tolerable misstatement at the account or disclosure level. When the population to be sampled constitutes a portion of an account balance or transaction class, the auditor should determine tolerable misstatement for the population to be sampled for purposes of designing the sampling plan. Tolerable misstatement for the population to be sampled ordinarily should be less than tolerable misstatement for the account balance or transaction class to allow for the possibility that misstatement in the portion of the account or transaction class not subject to audit sampling, individually or in combination with other misstatements, would cause the financial statements to be materially misstated.

l. Paragraph .20 is deleted.

m. The first sentence of paragraph .21, is replaced with the following sentence –

The sufficiency of tests of details for a particular account balance or class of transactions is related to the individual importance of the items examined as well as to the potential for material misstatement.

n. Paragraph .23 is replaced with –

To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account tolerable misstatement for the population; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements.

o. Paragraph .23A is added –

> Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

p. The last sentence of paragraph .25 is replaced with –

The auditor also should evaluate whether the reasons for his or her inability to examine the items have implications in relation to his or her risk assessments (including the assessment of fraud risk) the implications on the integrity of management or employees, and the possible effect on other aspects of the audit.

q. Footnote 6 to paragraph .26 is replaced with –

Paragraphs 11 through 23 of Proposed Auditing Standard, *Evaluating Audit Results,* discuss the auditor's consideration of differences between the accounting records and the underlying facts and circumstances.

r. Within footnote 7 to paragraph .32, the reference to section 319.85 is deleted. In the first sentence of the footnote, the phrase "often plans" is replaced with the phrase "may plan." The last sentence of the footnote, which is in brackets, is deleted.

s. The following sentences are added to the end of paragraph .38 –

When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

t. The fifth sentence of paragraph .39 is replaced with –

Paragraphs 44 through 46, of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, describe the auditor's responsibilities for performing procedures between the interim date of testing and period end.

u. In paragraph .39, the last sentence, which is in brackets, is deleted.

v. In paragraph .44:

- The first sentence is replaced with –

  In some circumstances the auditor may design a sample that will be used for dual purposes: as a test of control and a substantive test.

- The third sentence is replaced with –

  For example, an auditor designing a test of a control over entries in the voucher register may design a related substantive test at a risk level that is based on an expectation of reliance on the control to assess control risk at less than the maximum.

- The fifth sentence is replaced with –

  In evaluating such tests, deviations from the control that was tested and monetary misstatements should be evaluated separately using the risk levels applicable for the respective purposes.

- The following Note is added to the paragraph –

  > Note: Paragraph 47 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, provides additional discussion of the auditor's responsibilities for performing dual-purpose tests.

w. The reference in paragraph .45 to paragraph .04 is changed to paragraph .03.

x. In item 2 of paragraph .48, the last sentence is deleted.

y. The sentence in item 6 of paragraph .48, referring to section 313, which is in parentheses, is deleted.

z. Within footnote 1 to item 4 in paragraph .48, the sentence referring to section 313, which is in parentheses, is deleted.

AU sec. 9350, "Audit Sampling: Auditing Interpretations of Section 350"

AU sec. 9350, "Audit Sampling: Auditing Interpretations of Section 350" is superseded.

AU sec. 380, "Communication With Audit Committees"

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees") as amended, is amended as follows –

The reference in footnote 5 to paragraph .10 to section 316A.38 -.40 is replaced with a reference to AU sec. 316.79 - .82. The reference to section 316A is changed to section 316.

AU sec. 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles"

SAS No. 69, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles" (AU sec. 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles"), as amended, is amended as follows –

a. In paragraph .04, the reference to section 431 is replaced with a reference to paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results.*

b. The reference in footnote 1 to paragraph .04 to 312.10 is replaced with a reference to Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*.

AU sec. 431, "Adequacy of Disclosure in Financial Statements"

SAS No. 32, "Adequacy of Disclosure in Financial Statements" (AU sec. 431, "Adequacy of Disclosure in Financial Statements"), as amended, is superseded.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements" (AU sec. 508 "Reports on Audited Financial Statements"), as amended, is amended as follows –

a. In paragraph 18C, the phrase "and in AU sec. 431" is deleted.

b. In paragraph .20a., the word "competent" is replaced with the word "appropriate."

c. In the second sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."

d. In the third sentence of paragraph .24, the word "competent" is replaced with the word "appropriate."

e. In footnote 15 to paragraph .38, the first sentence is replaced with –

   In this context, practicable means that the information is reasonably obtainable from management's accounts and records and that providing the information in the report does not require the auditor to assume the position of a preparer of financial information.

f. The references in paragraph .49, to section 312, *Audit Risk and Materiality in Conducting an Audit*, and to section 342, *Auditing Accounting Estimates*, are replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*, paragraph 13.

g. In the first sentence of paragraph .63, the word "competent" is replaced with the word "appropriate."

h. In paragraph .66, the second sentence is replaced with –

   (See paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results.)*

AU sec. 9508, "Reports on Audited Financial Statements: Auditing Interpretations of Section 508"

AU sec. 9508, "Reports on Auditing Financial Statements: Auditing Interpretations of Section 508", is amended as follows –

In paragraph .02, the word "competent" is replaced with the word "appropriate."

AU sec. 530, "Dating of the Independent Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 530, "Dating of the Independent Auditor's Report" (AU sec. 530, "Dating of the Independent Auditor's Report"), as amended, is amended as follows –

a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."

b. In the second note to paragraph .01, the word "competent" is replaced with the word "appropriate."

c. In the first sentence of paragraph .05, the word "competent" is replaced with the word "appropriate."

AU sec. 543, "Part of Audit Performed by Other Independent Auditors"

SAS No. 64, "Part of Audit Performed by Other Independent Auditors" (AU sec. 543 Part of Audit Performed by Other Independent Auditors") is amended as follows –

Within paragraph .12 −

- Subparagraph b is replaced with –

  A list of significant risks, the auditor's responses, and the results of the auditor's related procedures.

- Subparagraph f is replaced with –

  A schedule of accumulated misstatements, including a description of the nature and cause of each accumulated misstatement, and an evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543"

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543," is amended as follows –

a. Paragraph .16 is replaced with –

   Interpretation − The principal auditor's response should ordinarily be made by the engagement partner. The engagement partner should take those steps that he considers reasonable under the circumstances to be informed of known matters pertinent to the other auditor's inquiry. For example, the engagement partner may inquire of engagement team members responsible for various aspects of the engagement or he may direct engagement team members to bring to his attention any significant matters of which they become aware during the audit. The principal auditor is not required to perform any procedures directed toward identifying matters that would not affect his audit or his report.

b. Footnote 4 to paragraph .16 is deleted.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows –

a. Within footnote 7 to paragraph .11 the first sentence is replaced with –

   Proposed Auditing Standard, *Evaluating Audit Results*, paragraphs 10 through 23, require the auditor to accumulate and evaluate the misstatements identified during the audit.

b. The reference in paragraph .13 to section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

c. Within the last sentence of paragraph .16, the title of section 329, "Analytical Procedures", is replaced with "Substantive Analytical Procedures."

d. Footnote 20, to paragraph .26 is deleted.

e. The reference in paragraph .56 subparagraph C5 to section 319 is replaced with a reference to section 316.

Auditing Standard No. 3, *Audit Documentation*

Auditing Standard No. 3, *Audit Documentation*, as amended, is amended as follows –

a. Within paragraph 3, subparagraph b is replaced with –

Supervisory personnel who review documentation prepared by other members of the engagement team.

b. Paragraph 9A is added –

Documentation of risk assessment procedures and responses to risks of misstatement should include (1) a summary of the identified risks of misstatement and the auditor's assessment of risks of material misstatement at the financial statement and assertion levels and (2) the auditor's responses to the risks of material misstatement, including linkage of the responses to those risks.

c. Within paragraph 12 –

- At subparagraph a., a footnote reference 2A has been added at the end of the first sentence;

  See paragraphs 12 through 13 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* and paragraphs .66-.67 of AU Section 316, *Consideration of Fraud in a Financial Statement Audit*.

  and the second sentence has been deleted.

- Subparagraph b. is replaced with –

  Results of auditing procedures that indicate a need for significant modification of planned auditing procedures, the existence of material misstatements (including omissions in the financial statements), the existence of significant deficiencies or material weaknesses in internal control over financial reporting.

- Subparagraph c. is replaced with –

  Accumulated misstatements and evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

- Footnote 2B is added to subparagraph c –

  See paragraphs 10 through 23 of Proposed Auditing Standard, *Evaluating Audit Results.*

- Subparagraph d is replaced with –

  Disagreements among members of the engagement team or with others consulted on the engagement about final conclusions reached on significant accounting or auditing matters including the basis for the final resolution of those disagreements. If an engagement team member disagrees with the final conclusions reached, he or she should document that disagreement.

- Subparagraph e-1. is added –

  Risks of material misstatement that are determined to be significant risks, and the results of the auditing procedures performed in response to those risks.

- Subparagraph f is replaced with –

  Significant changes in the auditor's risk assessments, including risks that were not identified previously, and the modifications to audit procedures or additional audit procedures performed in response to those changes.

- Footnote 2C is added to subparagraph f –

  See paragraph 74 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement* and paragraph 35 of Proposed Auditing Standard, *Evaluating Audit Results.*

d. Within paragraph 19 -

- Subparagraph b is replaced with –

A list of significant risks, the auditor's responses, and the results of the auditor's related procedures.

- Subparagraph f is replaced with –

  A schedule of accumulated misstatements, including a description of the nature and cause of each accumulated misstatement, and an evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

e. Paragraph 21 is deleted.

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, as amended, is amended as follows –

a. Within the note to paragraph 10, the reference to AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

b. In the first sentence of paragraph 18, the word "competent" is replaced with the word "appropriate."

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, is amended as follows –

a. In the second sentence of paragraph 3, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph 9, the phrase "any assistants" is replaced with the phrase "the members of the engagement team".

c. Within footnote 10 to paragraph 14, the reference to paragraphs .19 through .42 of AU sec. 316, *Consideration of Fraud in a Financial*

Statement Audit, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

d. The reference in paragraph 15 to AU sec. 316.44 and .45 is replaced with a reference to paragraphs 72 through 73 of the Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

e. Within footnote 11 to paragraph 20, the reference to AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*.

f. Within footnote 12 to paragraph 28, the reference to AU sec. 326, *Evidential Matter*, is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*.

g. Within footnote 13 to the note to paragraph 31, the reference to AU sec. 312.39 is replaced with a reference to paragraphs 13 and 14 of the Proposed Auditing Standard, *Evaluating Auditing Results*. The reference to AU sec. 316.50 is replaced with a reference to paragraph 5 of the Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

h. The references in paragraph 36 to paragraphs .16 through .20, .30 through .32, and .77 through .79 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, are replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* paragraph 62 and Appendix B.

i. In the first sentence of paragraph 51, the word "competent" is replaced with the word "appropriate."

j. In the first sentence of paragraph 89, the word "competent" is replaced with the word "appropriate."

k. Within the note to paragraph C6, the word "competent" is replaced with the word "appropriate."

Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*

Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* is amended as follows –

a. Footnote 3 to paragraph 4 is deleted.

b. In paragraph 10, the reference to section 431 is replaced with a reference to paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results.*

Auditing Standard No. 7, *Engagement Quality Review*

Auditing Standard No. 7, *Engagement Quality Review* is amended as follows –

a. Footnote 3 to paragraph 5 is replaced with –

> The term "engagement partner" has the same meaning as the "practitioner-in-charge of an engagement" in PCAOB interim quality control standard QC sec. 40, *The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement*. QC sec. 40 describes the competencies required of a practitioner-in-charge of an attest engagement.

b. In paragraph 10, the note following subparagraph b is replaced with –

> Note: A *significant risk* is a risk of material misstatement that requires special audit consideration.

Ethics Standards

ET sec. 102, "Integrity and Objectivity"

ET sec. 102, "Integrity and Objectivity," is amended as follows –

Within footnote 1 to paragraph .05, the reference to SAS No. 22, *Planning and Supervision* [AU Section 311] is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*.

RELEASE

APPENDIX 9

Additional Discussion of New Proposed Auditing Standards and Comments on Original Standards Proposed in October 2008

This appendix discusses the new proposed standards in Appendices 1-7 and the related amendments to PCAOB standards in Appendix 8. In particular, this appendix discusses changes to existing PCAOB standards and responses to comments received on the standards proposed in October 2008 ("original proposed standards") and related amendments.

General Areas of Comment on the Original Proposed Standards

The following paragraphs discuss general areas of comment on the original proposed standards and related amendments, as well as certain changes to the original proposed standards and related amendments in light of those comments.

1. Comparison with the Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

In developing its original proposed standards, the Board took into account, among other things, the risk assessment standards of the International Auditing and Assurance Standards Board ("IAASB").[1/] Several comments received on the original proposed standards related to differences between the IAASB standards and the original proposed standards. Also, many commenters referred to provisions of the IAASB standards when suggesting revisions to the original proposed standards.

The Board has considered these comments in developing the new proposed standards. Some revisions in the new proposed standards have resulted in eliminating differences from IAASB standards. However, because the Board's standards must be appropriate for audits of issuers and consistent with the Board's statutory mandate "to oversee the audit of public companies that are subject to the securities laws…in order to protect the interests of investors and further the public interest in the preparation of

[1/] After the Board released its original proposed standards, the Auditing Standards Board of the American Institute of Certified Public Accountants ("ASB") issued a proposed update of its risk assessment standards as part of its clarity project.

informative, accurate, and independent audit reports,"[2/] its standards necessarily will differ in some respects from IAASB standards.

Some differences from the IAASB standards reflect the Board's view that particular procedures described in the IAASB standards are not necessary for audits of issuers or that additional procedures not described in the IAASB standards are necessary. For example, the new proposed standards contain certain requirements adapted from existing PCAOB standards that are not described in IAASB standards. Also, certain differences in requirements are necessary to make the new proposed standards consistent with relevant provisions of the federal securities laws or other existing standards or rules of the Board.

Subsequent sections of this appendix discuss the Board's responses to specific comments received on the original proposed standards, including those related to the use of provisions in the IAASB standards. Appendix 10 of this release discusses specific differences between the new proposed standards and the analogous standards of the IAASB and the Auditing Standards Board of the American Institute of Certified Public Accountants ("ASB").

2. Alignment with Auditing Standard No. 5

Section 2.A. of this release discusses the Board's objective regarding aligning its risk assessment standards with Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

Several commenters supported the Board's efforts to align the risk assessment standards with Auditing Standard No. 5, agreeing that, in an integrated audit of financial statements and internal control over financial reporting ("integrated audit"), the risk assessment process is the same for both the audit of financial statements and the audit of internal control over financial reporting ("audit of internal control"). However, some commenters observed that, on the one hand, the original proposed standards did not include certain essential risk assessment procedures from Auditing Standard No. 5 that also applied to financial statement audits, and, on the other hand, the original proposed standards contained certain requirements regarding testing controls and evaluating audit results that applied only to the audit of internal control and are already included in Auditing Standard No. 5. Those commenters suggested incorporating into the risk

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[2/] Section 101 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7211.

assessment standards all of the Auditing Standard No. 5 requirements regarding risk assessment procedures and removing from the risk assessment standards all requirements for testing controls and evaluating audit results that apply only to the audit of internal control.

The new proposed standards incorporate the Auditing Standard No. 5 requirements related to identifying and assessing risks of material misstatement that also apply to financial statement audits. The new proposed standards omit requirements related only to the audit of internal control. As previously stated, the Board does not propose removing the requirements regarding risk assessment procedures from Auditing Standard No. 5 because those requirements are important to understanding the other provisions of Auditing Standard No. 5 for performing an audit of internal control.

3. Consideration of Fraud in the Audit

Section 2.B. discusses the Board's objectives regarding emphasizing the auditor's responsibilities for consideration of fraud by incorporating into its risk assessment standards the requirements for identifying and responding to risks, of material misstatement due to fraud ("fraud risks") and evaluating audit results from AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*[3/]

The views of commenters on the approach taken in the original proposed standards were mixed. Some commenters supported the approach because it placed greater emphasis on the auditor's responsibilities for consideration of fraud. Others indicated views that all of the requirements regarding fraud should be presented in a single auditing standard or were ambivalent about whether the changes would have an effect on audit practice.

The new proposed standards continue to include relevant requirements from AU sec. 316. The Board has observed from its oversight activities instances in which auditors have performed the procedures required in AU sec. 316 mechanically, without using the procedures to develop insights on fraud risk or modify the audit plan to

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[3/] Like the original proposed standards, the new proposed standards incorporate paragraphs .14 -.51 and .68 -.78 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. Accordingly, those paragraphs would be removed from AU sec. 316 by means of a related amendment. <u>See</u> Appendix 8.

address the risk and instances in which firms have failed to respond appropriately to identified fraud risks.

These kinds of deficiencies suggest that some auditors may view the consideration of fraud as an isolated, mechanical process rather than an integral part of audits under existing PCAOB standards. This integration would emphasize to auditors that assessing and responding to the risk of fraud is an integral part of an audit in accordance with existing PCAOB standards, rather than a separate consideration. Such integration also should prompt auditors to make a more thoughtful and thorough assessment of the risks affecting the financial statements, including fraud risks, and to develop appropriate audit responses. Furthermore, AU sec. 316, as amended, will continue to provide relevant information on determining the necessary procedures for considering fraud in a financial statement audit.

4. Requirements and the Application of Judgment

Some commenters expressed a view that the original proposed standards contained requirements that were "too prescriptive," limiting the auditor's ability to "use professional judgment or scale the audit." For example, the commenters observed that the original proposed standard on identifying and assessing risks of material misstatement had more requirements than the related IAASB standard. They also observed that the requirements in the original proposed standards did not refer to the auditor's judgment, particularly when corresponding requirements in the IAASB standards did so.

Existing PCAOB standards recognize that the auditor uses judgment in planning and performing audit procedures and evaluating the evidence obtained from those procedures.[4/] As under the existing PCAOB standards, auditors would need to exercise judgment in fulfilling the requirements of the new proposed standards in the particular circumstances. Making references to judgment in selected portions of the standards, however, could be misinterpreted as indicating that judgment is required only in certain aspects of the audit. Instead of referring to judgment selectively, the new proposed standards set forth the principles necessary for meeting the requirements of the new proposed standards, and allow the auditor to determine the most appropriate way to comply with the requirements in the circumstances. Also, the Board has re-examined

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[4/] See, e.g., paragraph .11 of AU sec. 230, *Due Professional Care in the Performance of Work.*

each requirement in the original proposed standards and has revised certain provisions in the new proposed standards to streamline the presentation of those requirements.

5. Use of Terms

PCAOB Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, sets forth the terminology used by the Board to describe the degree of responsibility that the auditing and related professional practice standards impose on auditors. The original proposed standards used terms in its requirements in a manner that was consistent with Rule 3101.

Several comments received on the original proposed standards related to the use of certain terms in the requirements of the standards. For example, several comments related to matters for which the original proposed standards stated that the auditor "should evaluate," "should assess," or "should take into account," whereas the existing PCAOB standards state that the auditor "should consider," and the IAASB standards use the term "shall consider." Some commenters suggested that the original proposed standards should use the term "should consider." They also asked about the meaning of the phrase "take into account."

The Board has reviewed these comments and the requirements in the original proposed standards and made certain revisions in the new proposed standards. The new proposed standards, like the original proposed standards, use "should consider" only when referring to a requirement to consider performing an action or procedure, which is consistent with PCAOB Rule 3101. The phrase "take into account" is not new. It has been used previously in PCAOB standards in reference to information or matters that the auditor should think about or give attention to in performing an audit procedure or reaching a conclusion.[5/] Accordingly, the results of the auditor's thinking on the relevant matters should be reflected in the performance and documentation of the respective audit procedure performed or conclusion reached.

6. Organization and Style of PCAOB Standards

Many commenters offered observations about the organization and style of the original proposed standards. They generally supported the practice of presenting an

[5/] AU sec. 316.45 and paragraphs 14, 44, 59, and B 12 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

objective in each standard. Some commenters suggested that the Board adopt a consistent approach to the organization and style of its standards, including the location of definitions within the standards.

The organization and style of the new proposed standards draws from previously issued standards of the Board and will provide a template generally to be followed in the future standards issued by the Board. Like Auditing Standard No. 7, *Engagement Quality Review,* each new proposed standard has an objective. Like Auditing Standard No. 5, some of the new proposed standards include appendices for definitions and special topics.

Some commenters asked about the role of objectives, notes, and appendices in the Board's standards, and they observed that some notes and appendices appear to include requirements. The Board has included objectives in the new proposed standards to provide additional context for understanding the requirements in the respective standards. As with other PCAOB standards, the auditor's responsibilities for complying with the standards are communicated using the terms set forth in PCAOB Rule 3101. The notes and appendices in the Board's auditing standards are considered as integral parts of the standards.[6/] Accordingly, the notes and appendices of the new proposed standards carry the same authoritative weight as the other portions of the new proposed standards.

7. Additional Discussion of Topics

Some commenters approved of the brevity of the original proposed standards, but they requested additional discussion of some specific topics. The Board has analyzed each of those requests and, in many instances, has added further explanation or examples in the new proposed standards. This Appendix discusses specific provisions that were added to the respective new proposed standards.

Question

1. Are the objectives in the new proposed standards useful in providing context for the requirements in the standards?

[6/] See Question Nos. 1 and 2 of *Staff Questions and Answers: Auditing Internal Control Over Financial Reporting* (June 23, 2004 and revised July 27, 2004).

RELEASE

Proposed Auditing Standard – Audit Risk

1. Background

The new proposed standard discusses audit risk and the relationships among the various components of audit risk in an audit of financial statements as part of an integrated audit and an audit of financial statements only. The descriptions of the components of audit risk and their relationships are similar to the respective discussions in existing PCAOB standards.[7/]

2. Objective of the Standard

The original proposed standard stated that the objective of the auditor is to conduct an audit of financial statements in a manner that reduces audit risk to an appropriately low level. This objective is retained without change from the original proposed standard.

A few commenters expressed concern that the objective in the original proposed standard was too broad because it related to the overall conduct of the audit. The Board believes that the objective of the standard is appropriate because it provides important context for understanding how the concept of audit risk is applied in an audit.

One commenter also suggested that the term, "…appropriately low level" should be revised to "…an acceptably low level." The Board believes the term "appropriately low level" is more suitable because it is aligned more closely with the degree of assurance expressed in the auditor's opinion, i.e., the auditor conducts the audit to reduce audit risk to an appropriately low level in order to express an opinion with reasonable assurance. In contrast, the term "acceptably low" could be misinterpreted as a matter of individual preference.

3. Due Professional Care and Sufficient Appropriate Audit Evidence

The original proposed standard stated that, to form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are

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[7/] These concepts are discussed primarily in AU sec. 312, *Audit Risk and Materiality in Conducting an Audit,* and AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit.*

free of material misstatement due to error or fraud. It also stated that reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care and obtaining sufficient appropriate audit evidence.[8/]

A commenter suggested that applying due professional care and obtaining sufficient appropriate audit evidence are related concepts and that the wording of the original proposed standard should be changed. The new proposed standard clarifies that obtaining sufficient appropriate audit evidence is part of applying due professional care.

4. Audit Risk and Risk of Material Misstatement

Although not mentioned in the comment letters, the Board believes that the original proposed standard could be enhanced by relating more clearly the concept of audit risk to the opinion expressed in the auditor's report. Thus, the new proposed standard states that audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial reporting framework. Similarly, the new proposed standard states that the risk of material misstatement refers to the risk that the financial statements are materially misstated, i.e., the financial statements are not presented fairly in accordance with the applicable financial reporting framework.

These expanded descriptions of audit risk and the risk of material misstatement emphasize the auditor's responsibility to plan and perform the audit to assess and respond to risks that would cause the financial statements to be not presented fairly in accordance with the applicable financial reporting framework.

Some commenters suggested that the description of the risk of material misstatement should indicate that the risk exists "prior to audit" to more clearly indicate that it is the company's risk. The Board agrees that the risk of material misstatement exists irrespective of the audit, while the risk of not detecting material misstatement is the auditor's risk. However, adding the suggested phrase is unnecessary because the new proposed audit risk standard already indicates that the risk of material misstatement exists independently of the audit. Also, the suggested phrase could be

[8/] See AU sec. 110, *Responsibilities and Functions of the Independent Auditor,* and AU sec. 230.

misinterpreted, e.g., as implying that the auditor need not consider the risk of misstatements occurring during the audit.

Some commenters suggested adding more explanation about risks at the overall financial statement level, e.g., by providing examples of such risks. The new proposed standard is expanded to elaborate further on risks at the financial statement level.

5. Integrated Audit Considerations

This new proposed standard applies both to audits of financial statements only and to the financial statement audit portion of integrated audits. Some commenters expressed concern that the language in the first paragraph of the original proposed standard implied that there are two distinct processes for the auditor's consideration of risk in the individual portions of the integrated audit.

The language in the original proposed standard was intended to acknowledge that the objectives of the audit of the financial statements and the audit of internal control are different, so the components of audit risk are not identical. Audit risk in the audit of financial statements relates to whether the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, while audit risk in an audit of internal control relates to whether the auditor expresses an inappropriate audit opinion when one or more material weaknesses exist. The two forms of audit risk are related, however, and the Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement,* indicates that the risk assessment procedures required by that new proposed standard apply to both the audit of financial statements and the audit of internal control. Thus, the language of the new proposed standard on audit risk clarifies its nature and purpose.

6. Detection Risk

The original proposed standard indicated that detection risk is reduced by performing substantive procedures. Some commenters suggested that the discussion of detection risk be modified to indicate that auditors can reduce detection risk through procedures other than substantive procedures (e.g., risk assessment procedures and test of controls).

The Board acknowledges that auditors might obtain evidence of misstatements through procedures other than substantive procedures. However, that does not diminish the auditor's responsibility to perform substantive procedures for significant accounts and disclosures that are sufficient to provide reasonable assurance of detecting misstatements that would result in material misstatement of the financial statements. Furthermore, the changes suggested by the commenters are not consistent with existing PCAOB standards[9/] and could be misunderstood by auditors, resulting in inadequate substantive procedures. However, the Board has made some revisions to clarify the discussion of detection risk in the new proposed standard.

Questions

2. Does the new proposed standard on audit risk describe clearly the concept of audit risk and its components?

3. Does the new proposed standard on audit risk describe clearly the relationship between detection risk and substantive procedures?

Proposed Auditing Standard – Audit Planning and Supervision

1. Background

This new proposed standard describes the auditor's responsibilities for planning the audit and supervising the work of engagement team members in integrated audits and audits of financial statements only. This new proposed standard would supersede AU sec. 311, *Planning and Supervision.*

2. Responsibilities of the Engagement Partner

Existing PCAOB standards state, "The auditor with final responsibility for the audit may delegate portions of the planning and supervision of the audit to other firm personnel."[10/] The new proposed standard uses the term "engagement partner" instead of "auditor with final responsibility for the audit" and states more directly that the engagement partner is responsible for planning the audit and supervising other engagement team members. The new proposed standard allows the engagement partner to seek assistance from appropriate engagement team members in fulfilling his or her planning and supervision responsibilities. Because the requirements in the

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[9/] AU secs. 319.81-.82.

[10/] Paragraph .02 of AU sec. 311, *Planning and Supervision.*

standard apply to anyone who performs planning or supervision activities, the requirements in the standard use the term "auditor."

3. Requirement to Properly Plan and Supervise

The original proposed standard included a statement, following the objective of the standard, that the auditor must properly plan the audit and supervise members of the engagement team. Some commenters questioned the placement of the requirement after the objective. The new proposed standard was revised by (1) dividing the proposed requirement into separate requirements regarding planning and supervision and (2) placing those separate requirements into the respective sections of the new proposed standard. Some commenters also observed that Auditing Standard No. 5 has a similar requirement for planning and supervising the audit of internal control but uses the term "should" instead of "must." The requirements in the original proposed standard have been modified to use the term "should" to align with the corresponding requirement in paragraph 9 of Auditing Standard No. 5.

4. Planning Activities

The original proposed standard stated that, as part of establishing the audit strategy and audit plan, the auditor should evaluate whether certain matters specified in the standard are important to the company's financial statements and internal control over financial reporting ("internal control") and, if so, how they would affect the auditor's procedures. The requirement in the original proposed standard is the same as in paragraph 9 of Auditing Standard No. 5, thus extended its application to an audit of financial statements. Several commenters suggested removing the requirement from Auditing Standard No. 5. Other commenters suggested changes to the requirement, including deleting some of the matters discussed in the requirement, moving other matters elsewhere within the proposed standard, or including additional matters.

The Board considered the suggested changes to the original proposed standard and determined that those changes would not substantially improve the proposed standard. Also, the Board believes that it is important for the language in this requirement to be identical to the language in Auditing Standard No. 5 to emphasize that this required procedure is to be performed only once in an integrated audit, with the results of the procedure to be applied in planning both the financial statement audit and the audit of internal control.

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5. Requirements for Multi-location Engagements

The original proposed standard carried forward the existing requirements for multi-location engagements from AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, and Auditing Standard No. 5 with little change. Some commenters suggested that the requirements in the original proposed standard should be aligned more closely with Auditing Standard No. 5, e.g., by incorporating more provisions from Auditing Standard No. 5.

The Board agrees that aligning the multi-location requirements in the original proposed standard with those in Auditing Standard No. 5 would improve the original proposed standard and could facilitate better integration of the financial statement audit and the audit of internal control. The original proposed standard has been revised to align more closely with Auditing Standard No. 5 and to refine the provisions regarding consideration of risks in individual locations. For example, like Auditing Standard No. 5, the new proposed standard directs the auditor to take into account the risks associated with the location or business unit that present a reasonable possibility of material misstatement to the company's consolidated financial statements.

6. Persons with Specialized Skill or Knowledge

The original proposed standard included requirements to determine the need for specialized skill or knowledge to perform appropriate risk assessments, apply the planned audit procedures, or evaluate audit results. The original proposed standard generally retained requirements from AU sec. 311.10 and paragraphs .31-.32 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit,* related to the use of persons with information technology ("IT") skill or knowledge. However, the language in the original proposed standard was changed to expand the application to specialized skill or knowledge in areas besides IT, such as valuation specialists, actuarial specialists, and forensic specialists. Commenters generally agreed with this change but suggested that the original proposed standard include a list of examples of specialists that might be used in conducting an audit. A list of possible specialists was not added to the new proposed standard because the types of specialized skill or knowledge that might be needed on a particular audit depend on the particular circumstances and the skills and knowledge of the engagement team.

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The original proposed standard also included a requirement regarding the knowledge of the subject matter needed by an auditor who is working with a person[11/] with specialized IT skill or knowledge. Some commenters suggested that this requirement should not be limited to situations involving only persons with specialized IT skill or knowledge. Some commenters also suggested that the original proposed standard should state that any specialist that functions as a member of the engagement team requires the same supervision as any other member of the engagement team.

The requirements in paragraphs 16-17 in the new proposed standard were revised to apply to situations in which a person with specialized knowledge or skill employed or engaged by the auditor participates in the audit. Paragraph 17 describes the required level of knowledge of the subject matter in terms of the general types of procedures that the auditor should be able to perform with regard to the person with specialized skill or knowledge. Paragraph 17, by itself, does not impose procedural requirements for working with persons with specialized skill or knowledge because those responsibilities already are described in either the supervision provisions of the new proposed standard or AU sec. 336, *Using the Work of a Specialist*, as applicable. Paragraphs 18-19 explain when the supervision requirements in the new proposed standard apply and when the requirements of AU sec. 336 apply.

Paragraph 18 states that the supervision requirements in the new proposed standard apply to supervision of a person with specialized skill or knowledge who participates in the audit and is either (a) employed by the auditor or (b) engaged by the auditor to provide services in a specialized area of accounting or auditing. This paragraph applies the supervision provisions of the new proposed standard to situations in which a person with specialized skill or knowledge participates in the audit, except for those situations that are covered by AU sec. 336. Paragraph 19 explains how the audit procedures listed in paragraph 17 are addressed in AU sec. 336.

Paragraphs 18-19 are intended to maintain the relationship between the standards for planning and supervision and the use of the work of specialists that currently exists in PCAOB standards. For example, AU sec. 336.05 is consistent with the principle that firms should be able to supervise their own employees who are specialists. It should be noted, however, that the Board has a separate standards-setting project regarding using the work of specialists. This project will include a

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[11/] Under PCAOB Rule 1001(p)(iv), the term "person" means any natural person or any business, legal or governmental entity or association.

comprehensive review of AU sec. 336 and is likely to result in changes to the auditor's responsibilities regarding persons with specialized knowledge and skills, including changes to paragraphs 18-19 of the new proposed standard.

7. Supervision

The original proposed standard adapted the supervision requirements from AU sec. 311 with some conforming changes to align more closely with the other new proposed standards. Some commenters observed that the original proposed standard included requirements that were overlapping and redundant, and the new proposed standard has been revised to streamline the description of the supervision requirements.

The new proposed standard states that the auditor should properly supervise the engagement team members, i.e., the persons who participate in the audit. Existing PCAOB standards use either the term "engagement team members" or the term "assistants." This new proposed standard uses "engagement team members," which is consistent with the other new proposed standards.

The new proposed standard also describes the general elements of proper supervision of engagement team members by the engagement partner (and those who assist the engagement partner in supervision), which apply unless specified otherwise in PCAOB standards. For example, consistent with paragraph 19 of the new proposed standard, the auditor should look to the provisions of AU sec. 336 rather than the supervision provisions of the new proposed standard when using the work of specialists engaged by the auditor in accordance with AU sec. 336.

It should be noted that the Board has other standards-setting projects that are likely to result in future revisions of the provisions of the new proposed standard. For example, the Board has a separate standards-setting project regarding using the work of specialists, which will involve a comprehensive review of AU sec. 336 and the auditor's responsibilities regarding persons with specialized knowledge and skills.

8. Differences of Opinion within an Engagement Team

The original proposed standard included a requirement, adapted from AU sec. 311.14, that the engagement partner and other engagement team members should make themselves aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among the engagement team members.

Some commenters questioned how they would demonstrate compliance with a requirement to make themselves aware of the matters described in the standard.

Since the intention of including this provision was to require adequate documentation of disagreements, this paragraph has been removed from the new proposed standard, and the documentation requirements from the original proposed standard have been incorporated into an amendment of Auditing Standard No. 3, *Audit Documentation.*[12/]

Questions

4. Are the proposed requirements for multi-location engagements appropriately aligned with Auditing Standard No. 5?

5. Is it clear how the proposed requirements for multi-location engagements would be applied in audits of financial statements only?

6. Are the differences between the responsibilities for supervision of engagement team members and oversight of specialists in accordance with AU sec. 336 appropriate in light of the auditor's responsibilities to opine with reasonable assurance on whether the financial statements are fairly presented, in all material respects, in conformity with the applicable financial reporting framework?

Proposed Auditing Standard – Consideration of Materiality in Planning and Performing an Audit

1. Background

This proposed standard sets forth the auditor's responsibilities for applying the concept of materiality, as described by the federal securities laws, in planning the audit and determining the scope of the audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements. It would apply to integrated audits and audits of financial statements only.

[12/] Paragraph 12.d. of Auditing Standard No. 3, *Audit Documentation.*

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2. Materiality in the Context of an Audit

The original proposed standard discussed the concept of materiality as described in the financial reporting frameworks and included an example from Financial Accounting Standards Board ("FASB") Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information.* Subsequent to the issuance of the original proposed standard, the FASB has published its accounting standards codification, which does not include the FASB Concepts Statements.

More importantly, although the discussion of materiality in applicable financial reporting frameworks might help readers understand how accounting standard setters view materiality in the context of preparation and presentation of financial statements, the concept of materiality that applies to audits of issuers is that used by the courts in interpreting the federal securities laws. The Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." (TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).) Accordingly, the requirement in the new proposed standard regarding how the auditor should determine materiality is based on the courts' articulation of the concept of materiality, and the discussion of financial reporting frameworks has been removed.

3. Establishing a Materiality Level for the Financial Statements as a Whole

The original proposed standard indicated that the auditor should establish an appropriate materiality level for the financial statements as a whole. This materiality level should be established in light of the particular circumstances. For example, if a company's net earnings were the most important factor in the total mix of information available to a reasonable investor, then the company's earnings should be taken into account in establishing the materiality level for the financial statements taken as a whole. On the other hand, financial statement elements other than net earnings might be more important to a reasonable investor depending on the company's industry or operations, e.g., if the company has minimal net income or loss. Accordingly, the new proposed standard states that establishing materiality for the financial statements as a whole includes consideration of the company's earnings and other relevant factors. Observations from the Board's oversight activities have included instances in which firms have determined materiality levels using methods that do not consider elements of the financial statements that may be important to reasonable investors.

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The original proposed standard also included a statement that, when planning the audit, the auditor's materiality level for the financial statements as a whole needs to be expressed as a specified amount. This statement reflects the fact that, as a practical matter, many of the auditor's decisions involving planning the scope of the audit are quantitative, e.g., decisions about the number of items to be selected in performing a substantive audit procedure.

Some commenters on this section of the original proposed standard suggested adding further explanation on how to establish a materiality level for the financial statements as a whole. Some of those commenters suggested certain quantitative guidelines that might be used to establish a materiality level. The new proposed standard does not contain additional provisions regarding establishing a materiality level for the financial statements. The concept of materiality is already articulated by the courts. That concept reflects the perspective of a reasonable investor and is necessarily dependent on the particular circumstances. The Board does not prescribe particular quantitative guidelines in establishing materiality levels nor prohibit the use of quantitative guidelines, as long as the guidelines are consistent with the perspective of a reasonable investor and appropriate in light of the particular circumstances.

4. Qualitative Considerations

The concept of materiality involves consideration of both quantitative and qualitative factors. Under the original proposed standard and the new proposed standard, qualitative considerations can affect the auditor's establishment of materiality levels in the following ways:

- Establishing a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This involves matters such as consideration of the elements of the financial statements that are more important to a reasonable investor and level of misstatements that would influence the judgment of a reasonable investor.

- Establishing lower levels of materiality for certain accounts or disclosures when, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. The formulation in the proposed standard is consistent with the principle of considering the perceptions of investors when making materiality judgments because it recognizes that, in certain circumstances, misstatements in some accounts might have more significant consequences than in other accounts. The following are a few examples of situations in which a lower materiality threshold might be needed:

- o Laws, regulations, or the applicable financial reporting framework affect investors' expectations about the measurement or disclosure of certain items, e.g., related party transactions and compensation of senior management.

- o Significant attention has been focused on a particular aspect of a company's business that is separately disclosed in the financial statements, e.g., a recent business acquisition.

- o Certain disclosures are particularly important to investors in the industry in which the company operates.

The new proposed standard does not allow the auditor to establish a materiality level for an account or disclosure at an amount that exceeds materiality for the financial statements as a whole.

The original proposed standard included the statement, adapted from existing PCAOB standards, that auditors should be alert for misstatements that are material based on qualitative factors, but ordinarily it is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors.[13/] One commenter expressed a concern about how an auditor would demonstrate that he or she was alert for misstatements that might be material for qualitative reasons. Another commenter expressed a concern that statement was placed in a note rather than in the body of the paragraph. This statement was moved to the body of the paragraph and revised to clarify that being alert for misstatements that could be material for qualitative reasons is part of the overall requirement to plan and perform the audit to detect misstatements that would, individually or in combination, result in material misstatement of the financial statements. Some commenters suggested removing the word "ordinarily" from the statement that "it ordinarily is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors." Another commenter stated that it is possible to design audit procedures to

[13/] AU sec. 312.20.

detect such misstatements. The new proposed standard retains the statement that ordinarily it is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors. This statement reflects the principle that judgments about whether a particular misstatement is material involve consideration of the particular circumstances, including the nature of the misstatement and its effect on the financial statements. Also, if an auditor is aware of potential misstatements that would be material based on qualitative factors, he or she has a responsibility to design audit procedures to detect such misstatements.

Commenters on these provisions of the standard also recommended that the Board revise the language of the standard to replace references to "reasonable investor" with "user," because Auditing Standard No. 5 refers to users of the auditor's report and because other parties besides investors might use the audited financial statements. The new proposed standard continues to use the term "reasonable investor" to align with the articulation used by the courts.

5. Tolerable Misstatement and Performance Materiality

The original proposed standard included requirements for the auditor to determine tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level. Tolerable misstatement is a concept used in determining the scope of audit procedures. Paragraph .18 of AU sec. 350, *Audit Sampling*, indicates that tolerable misstatement is the maximum amount of misstatement in an account or a class of transactions that may exist without causing the financial statements to be materially misstated. Tolerable misstatement is required to be set at an amount less than the materiality level for the financial statements and, if applicable, for particular accounts or disclosures.

Some commenters suggested replacing the term "tolerable misstatement" in the original proposed standard with the term "performance materiality," primarily because the latter term is used in the International Standards on Auditing ("ISAs"). One commenter recommended retaining the term "tolerable misstatement" because it is already well understood by auditors.

The Board decided to retain the term "tolerable misstatement" in its standards. That concept is already understood by auditors, and the Board is not seeking to change the concept as described in existing PCAOB standards. Also, tolerable misstatement necessarily reflects an auditor perspective because it considers the potential undetected misstatement in the accounts and disclosures, whereas materiality, as used in the new proposed standard, reflects a reasonable investor's perspective. Also, since the new term "performance materiality" contains the word "materiality," it could be misunderstood, e.g., by non-auditors, as having a meaning other than that intended in the new proposed standard.

6. Consideration of Materiality for Multi-location Engagements

The release accompanying the original proposed standards specifically sought comment on whether the standard should specifically address consideration of materiality in multi-location engagements. One commenter suggested that the standards should address materiality considerations in multi-location engagements.

The Board agrees that specific provisions regarding materiality determinations in multi-location engagements would be appropriate because of the importance of those determinations to the scope of testing at individual locations. The Board added a new paragraph to the new proposed standard, which states –

> For purposes of the audit of the consolidated financial statements of a company with multiple locations or business units, the auditor should establish the materiality level to be used in performing audit procedures at the locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements. Accordingly, materiality at an individual location cannot exceed, and generally should be less than, materiality for the financial statements as a whole.

This requirement is an application of the fundamental principles in the new proposed standard to audits of consolidated financial statements of companies with multiple business units or locations. For example, if the auditor plans to perform procedures at selected locations or business units, the auditor generally should establish the materiality level for the selected locations or business units to be lower than the materiality level for the consolidated financial statements to allow for the possibility that uncorrected and undetected misstatements in the selected locations or business units and potential undetected misstatements in untested locations or business units could exceed the materiality level for the consolidated financial statements.

7. Reassessing Materiality

The original proposed standard required the auditor to reassess the established materiality level or levels and tolerable misstatement in certain situations specified in the standards, which relate to the changes in the financial statement amounts upon which the materiality level or levels were based. This requirement recognizes that the materiality levels used in planning and performing the audit often are based initially on estimated financial statement data and reassessed when year-end financial statement data becomes available or when the financial statements are adjusted significantly.

Although not specifically addressed in comment letters, the Board believes that this requirement should be revised to reflect the broader principle that the materiality and tolerable misstatement should be reassessed if changes in the particular circumstances or additional information come to the auditor's attention that is likely to affect the judgments of a reasonable investor. This principle would encompass the situations described in the preceding paragraph as well as other situations, such as the following:

- Changes in laws, regulations, or the applicable financial reporting framework affect investors' expectations about the measurement or disclosure of certain items.

- Significant new contractual arrangements have attracted attention on a particular aspect of a company's business that is separately disclosed in the financial statements.

The reassessment of materiality is important because if that reassessment results in a lower amount for the materiality level or levels or tolerable misstatement than the auditor's initial determination, the auditor should (1) evaluate the effect, if any, of the lower amount or amounts on his or her risk assessments and audit procedures and (2) modify the nature, timing, and extent of audit procedures as necessary to obtain sufficient appropriate audit evidence.

<u>Questions</u>

7. Are the provisions in the new proposed standard regarding consideration of materiality in multi-location engagements appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect

misstatements that, individually or in combination, would result in material misstatement of the financial statements?

8. Are the revised provisions regarding reassessment of materiality appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?

Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement

1. Background

This new proposed standard describes the auditor's responsibilities for the process of identifying and assessing risks of material misstatement in an audit of financial statements only and in an integrated audit. This process includes performing (1) information-gathering procedures, known as "risk assessment procedures," and (2) identifying and assessing the risks of material misstatement using information obtained from the risk assessment procedures.

This new proposed standard brings together requirements from certain existing PCAOB standards, [14] adds new provisions regarding certain risk assessment procedures, and sets forth a new process for assessing those risks, including the determination of significant risks.

2. Objective of the Auditor

The original proposed standard stated that the objective of the auditor was to identify and appropriately assess the risks of material misstatement. Several commenters stated that the objective did not establish the necessary linkage between identifying and assessing the risks of material misstatement and responding to those risks. The Board agrees that proper linkage between the auditor's risk assessments and responses is essential to an effective risk-based audit, so the objective in the new proposed standard indicates that the auditor's risk assessments provide a basis for the auditor's response.

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[14] Those standards include AU sec. 311, AU sec. 312, AU sec. 316, AU sec. 319, AU sec. 329, *Substantive Analytical Procedures*, and Auditing Standard No. 5.

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3. Top-down Approach

Some commenters suggested that the original proposed standard should specifically direct the auditor to use a top-down approach, as Auditing Standard No. 5 requires for the audit of internal control.

The Board agrees that a top-down approach should be used in identifying and assessing the risks of material misstatement. Such an approach begins at the financial statement level and with the auditor's overall understanding of the company and its environment and works down to the significant accounts and disclosures and their relevant assertions. The process described in the original proposed standard is a top-down approach, so adding a specific requirement to apply a top-down approach is unnecessary. Instead, the new proposed standard contains a note that emphasizes the use of a top-down approach.

4. Size and Complexity of the Company

The size and complexity of the company can affect the risks of misstatement and the controls necessary to address those risks. Scaling the audit is most effective as a natural extension of the risk-based approach and applies to all audits. The procedures in the new proposed standard are designed to be scalable to companies of varying size and complexity. Although some commenters indicated that the original proposed standard is appropriately scalable, other commenters suggested that the original proposed standard should explain how the size and complexity of the company affects the risk assessment process. Certain notes have been added to the new proposed standard to discuss scaling the audit based on a company's size and complexity.

5. Risk Assessment Procedures

Under the new proposed standard, the overarching requirement for risk assessment procedures is that the auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of the risks of material misstatement due to error or fraud and to design further audit procedures.[15/] The new proposed standard also discusses the auditor's responsibilities

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[15/] The phrase "design further audit procedures" applies to substantive procedures and to tests of controls in the audit of financial statements and the audit of internal control over financial reporting.

for determining and performing the risk assessment procedures necessary to satisfy that overarching requirement.

Risks of material misstatement may exist at the financial statement level or at the assertion level. Risks of material misstatement also can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control. Since the risks of material misstatement come from various sources, the auditor's risk assessment procedures need to encompass both external factors and company-specific factors. The new proposed standard requires risk assessment procedures related to the following areas:

- Obtaining an understanding of the company and its environment;
- Obtaining an understanding of the company's internal control;
- Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company;
- Performing analytical procedures;
- Conducting a discussion among engagement team members; and
- Inquiring of the audit committee, management, and others within the company.

The new proposed standard's risk assessment procedures are designed to help the auditor identify the areas of greater risk so the auditor can design and perform audit procedures to address those risks. For example, a company's financial statements could be susceptible to misstatement because of lack of financial reporting competencies of company personnel, failures in information systems to accurately capture business transactions, or inadequate alignment between financial reporting processes and the requirements in the accounting standards. The following provisions of the new proposed standard, among others, could lead to identification of the sources of potential misstatements in those situations, along with the accounts or disclosures that could be affected:

RELEASE

- Understanding the selection and application of accounting principles, including, among other things –
    - Significant changes in the company's accounting principles, financial reporting policies, or disclosures and the reasons for such changes,
    - The methods the company uses to account for significant and unusual transactions,
    - The accounts or disclosures in which judgment is used in the application of significant accounting principles,
    - The financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles,
    - Financial reporting standards, laws, and regulations that are new to the company and when and how the company will adopt such requirements (paragraph 12),
- Obtaining an understanding of the procedures, within both automated and manual systems, by which transactions are initiated, authorized, processed, recorded and reported (paragraph 28),
- Understanding the company's objectives, strategies, and relevant business risks (paragraph 14),
- Understanding the sources of the company's earnings (paragraph 10), and
- Evaluating whether significant changes in the company from prior periods, including changes in its internal control, affect the risks of material misstatement (paragraph 8).

Similarly, if external or company-specific factors create pressures to manipulate the financial statements to achieve certain financial targets, the following are examples of provisions in the new proposed standard that could lead to identification of those incentives or pressures and the accounts or disclosures that are most susceptible to misstatement:

- Understanding the nature of the company, including –
  - Sources of funding of the company's operations and investment activities,
  - The company's significant investments including equity method investments, joint ventures, and variable interest entities (paragraph 10),
- Reading public information about the company (paragraph 11),
- Observing or reading transcripts of earnings calls (paragraph 11),
- Obtaining an understanding of compensation arrangements with senior management (paragraph 11),
- Obtaining information about trading activities in the company's securities and holdings by significant holders in the company's securities (paragraph 11),
- Obtaining an understanding of relevant performance measures (paragraph 16),
- Understanding the company's selection and application of accounting principles, including the accounts or disclosures in which judgment is used in the application of significant accounting principles, especially in determining management's estimates and assumptions (paragraph 12),
- Conducting a brainstorming session about ways in which the financial statements could be manipulated (paragraph 46), and
- Performing analytical procedures to identify unexpected trends or relationships that could present risks of material misstatement (paragraphs 43).

Some commenters expressed a view that the original proposed standard contained duplicative and prescriptive requirements, limiting the auditor's ability to use professional judgment and to scale the audit. For example, the commenters observed that the original proposed standard on identifying and assessing risks of material misstatement had more requirements than the related IAASB standard.

Because of the importance of the auditor's risk assessments to an effective risk-based audit, the Board believes that the standard must contain rigorous requirements for performing risk assessment procedures and assessing the risks of material misstatement. However, in light of the comments received, the Board has re-examined each unconditional or presumptively mandatory responsibility in the proposed standard and has revised certain provisions of the original proposed standard to streamline the description of the requirements and to clarify certain other provisions.[16/]

6. Obtaining an Understanding of the Company and its Environment

The new proposed standard requires the auditor to obtain an understanding of the company and its environment to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. The requirements in the original proposed standard were an expansion of the requirements in AU sec. 311.06-.09 on obtaining knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics as part of audit planning. The expansion of the requirements is important because existing standards do not focus sufficiently on the degree of knowledge of the company that is necessary for a risk-based audit or explain how that knowledge informs the auditor's identification and assessment of risk.

The necessary understanding of the company and its environment includes understanding the following:

- Relevant industry, regulatory, and other external factors;
- The nature of the company;
- The company's selection and application of accounting principles;
- The company's objectives and strategies and those related business risks that might reasonably be expected to result in risks of material misstatement; and

[16/] Examples of provisions of the new proposed standard that have been revised include paragraphs 7, 11, 12, 20, and 24.

- The company's measurement and review of its financial performance.

The new proposed standard then explains each of those aspects of the company and its environment. The discussion of relevant industry, regulatory, and other external factors is adapted from AU sec. 311. The discussion of the nature of the company is also adapted from AU sec. 311 and has been updated to reflect certain changes in business practices since the existing standard was originally issued (e.g., to encompass alternative investments and financing arrangements and to recognize the development of new business models).

Existing PCAOB standards recognize that financial reporting risks can arise due to circumstances such as changes in operating environment; new personnel; new or revamped information systems; rapid growth; new technology; new business models, products, or activities; corporate restructurings; expanded foreign operations; and new accounting pronouncements.[17/] The original proposed standard specifically required, and the new proposed standard continues to require, the auditor to evaluate the effect of significant changes in the company from prior periods, including changes in internal control, on the risks to the financial statements. Commenters suggested that this requirement be expanded further to take account of significant ongoing matters. The commenters' suggested revision is reflected in a subsequent provision of the new proposed standard regarding consideration of matters noted in past audits in paragraphs 39-40.

Additional Procedures to Obtain an Understanding of the Company and its Environment

The original proposed standard presented a list of additional procedures that the auditor should consider performing as part of obtaining an understanding of the company and its environment related to reading public information about the company, observing or reading transcripts of earnings calls, obtaining an understanding of compensation arrangements with senior management, and obtaining information about significant unusual developments regarding trading activity in the company's securities.

Members of the Board's Standing Advisory Group ("SAG")[18/] suggested that these matters could provide valuable information for identifying risks of material

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[17/] AU sec. 319.38.

[18/] February 16, 2005. Webcasts of SAG meetings are available on the Board's website at www.pcaobus.org/News_and_Events/Webcasts.

misstatement in many audits of issuers, e.g., to obtain information about business risks relevant to financial reporting or to identify incentives or pressures on management to manipulate financial results. Also, the Public Oversight Board, *Panel on Audit Effectiveness, Report and Recommendations* ("PAE Report"), recommended that auditors consider published analysts' reports and forecasts when gaining an understanding of the company's business and industry, assessing risks, and evaluating identified misstatements.[19/] The Board believes that these procedures can provide important information on many audits, so the new proposed standard establishes a responsibility for auditors to consider performing these procedures in each audit. The auditor's decisions about whether to perform one or more of the additional procedures should be informed by whether the matters addressed in those procedures are important to the company's internal control or financial statements[20/] and whether such procedures are necessary to meet the overall requirements for obtaining an understanding of the company and performing risk assessment procedures.[21/]

Some commenters expressed concerns about the practicality of the procedures for reading public information and understanding unusual trading activity. The new proposed standard includes revised language and examples to clarify the intent of those procedures. Also, the provision regarding observing or reading transcripts of earnings calls has been expanded to include, if publicly available, other meetings with investors or rating agencies, since those other meetings could also provide relevant information.

Selection and Application of Accounting Principles

PCAOB standards require auditors to obtain an understanding of the accounting practices common to the industry and to evaluate the quality of a company's accounting principles as part of his or her response to fraud risks and in determining matters to be communicated to the audit committee.[22/] The new proposed standard imposes a responsibility to obtain an understanding of the applicable financial reporting framework and to evaluate whether the company's selection and application of accounting

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[19/] Public Oversight Board, *Panel on Audit Effectiveness, Report and Recommendations* ("PAE Report") (August 31, 2000), p. 58.

[20/] See paragraph 9 of Proposed Auditing Standard, *Audit Planning and Supervision.*

[21/] See paragraphs 4 and 7 of the new proposed standard.

[22/] See AU sec. 316 and AU sec. 380, *Communication with Audit Committees*.

RELEASE

principles is consistent with the applicable accounting framework and the accounting principles used in the relevant industry. Such procedures can provide important information for identifying relevant matters such as (1) accounts that are susceptible to misstatement, e.g., if an account balance is determined using accounting principles that are inconsistent with the applicable financial reporting framework or (2) more general conditions that affect risks of material misstatement, e.g., if the company's selection or application accounting principles is more aggressive than the relevant industry.

The new proposed standard also presents a list of matters that, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles. The amount of auditor attention devoted to an individual matter would depend on its importance in meeting the overall requirements for obtaining an understanding of the company and performing risk assessment procedures.[23/]

The new proposed standard includes a new requirement to identify the necessary disclosures for the company's financial statements. This provision is not intended to require the auditor to evaluate the company's disclosures as part of the risk assessment process. Instead, it would require the auditor to develop expectations about the types of disclosures that would be necessary based on the information obtained about the company and its industry. This requirement should prompt auditors to be more thoughtful and thorough in their approach to testing and evaluating disclosures.

Company Objectives, Strategies, and Related Business Risks

The new proposed standard would require the auditor to obtain an understanding of the company's objectives, strategies, and related business risks in order to identify those business risks that could result in material misstatement of the financial statements, which the ISAs also require. The *PAE Report* recommended that auditors be required to obtain an understanding of the company's business risks.[24/] The new proposed standard provides examples of business risks that might result in a risk of material misstatement of the financial statements. Auditors would need to consider the business risks that are relevant to the particular company and industry.

[23/] See paragraphs 4 and 7 of the new proposed standard.

[24/] See *PAE Report,* p. 20.

RELEASE

Company Performance Measures

The risk assessment procedures required by the original proposed standard included obtaining an understanding of the company's performance measures. The purpose of obtaining that understanding is to identify those performance measures, whether external or internal, that affect the risks of material misstatement. For example, understanding performance measures can help the auditor to identify accounts or disclosures that might be susceptible to manipulation to achieve certain performance targets (or to conceal failures to achieve those targets) or to understand how management uses performance measures to monitor risks affecting the financial statements.

Some commenters asked for clarification regarding the list of examples of relevant performance measures in the original proposed standard, particularly the example of measures used in monitoring controls. After reviewing the comments, the Board included another example relating to external performance measures and clarified how the monitoring controls example relates to financial statement risks.

7. Obtaining an Understanding of Internal Control Over Financial Reporting

The new proposed standard describes the auditor's responsibilities regarding obtaining an understanding of internal control over financial reporting ("understanding of internal control"). Although the auditor's primary focus is on internal control over financial reporting, the new proposed standard also indicates that the auditor may obtain an understanding of controls related to operations or compliance objectives if they pertain to data the auditor plans to use in applying auditing procedures. These requirements are, in substance, equivalent to those in AU sec. 319, but the language has been revised to align more clearly with Auditing Standard No. 5.

The new proposed standard sets forth certain principles regarding the sufficiency of the auditor's understanding of internal control. The new proposed standard requires the auditor to obtain a sufficient understanding of each component of internal control to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures. The new proposed standard also indicates that the nature, timing, and extent of procedures necessary to obtain an understanding of internal control depend on the size and complexity of the company; the auditor's existing knowledge of the company's internal control; the nature of the company's internal controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control. For example, the auditor's procedures to obtain an understanding of internal control would be more extensive when the auditor plans to test controls more extensively (e.g., in an integrated audit), the company's internal control is more complex, or the company's controls have changed significantly.

Like the Board's existing standards,[25/] the new proposed standard indicates that the understanding of internal control includes evaluating the design of controls and determining whether the controls are implemented. In accordance with the principles in the new proposed standard, the amount of audit attention devoted to design and operating effectiveness will vary based on the auditor's plan for testing controls. For example, if the auditor plans to test controls, more attention should be devoted to controls that the auditor plans to test.

Description of Internal Control Components

To describe the auditor's responsibilities for obtaining an understanding of internal control, it was necessary to describe the components of internal control. The components described in the proposed standard are similar to those used in the Board's existing standard, AU sec. 319. However, auditors may use other suitable recognized frameworks[26/] in accordance with the provisions of the new proposed standard. If the auditor uses a suitable, recognized internal control framework with components that differ from those in the new proposed standard, the auditor should adapt the requirements in the new proposed standard to conform to the components in the framework used.

Control Environment

The Board's existing standard requires the auditor to consider the collective effect on the control environment of strengths and weaknesses in the various control environment factors.[27/] The new proposed standard requires the auditor to assess the following matters as part of obtaining an understanding of the control environment:

25/ AU sec. 319.58.

26/ See Securities Exchange Act Release No. 34-47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

27/ AU sec. 319.35-.36.

- Whether management's philosophy and operating style promote effective internal control;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

This new requirement in the new proposed standard is aligned more clearly with the requirements in Auditing Standard No. 5 for evaluating the control environment. However, the Board does not expect that the auditor's process for assessing the control environment in an audit of financial statements only to be the same as that required when expressing an opinion on internal control. For audits of financial statements only, the new proposed standard allows the auditor to base his or her assessment on evidence obtained as part of obtaining an understanding of the control environment and other relevant knowledge possessed by the auditor.

Because of the importance of the control environment to effective internal control, both the original proposed standard and the new proposed standard include a new requirement, which provides that if the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor.

Understanding of Information System Relevant to Financial Reporting

The new proposed standard would expand the auditor's responsibility for obtaining an understanding of the information system relevant to financial reporting in two respects. First, the new proposed standard requires the auditor to obtain an understanding about relevant business processes relating to financial reporting. This was also a recommendation in the PAE Report[28/] and is necessary for the auditor to understand the how the information system processes the company's transactions. The new proposed standard also discusses determining relevant business processes.

[28/] *PAE Report,* p. 15.

RELEASE

Second, the new proposed standard expands the requirements for understanding the period-end financial reporting process[29/] by describing important elements of that process. Because that process is a common source of potential misstatements, the Board believes that it is important for the auditor to have an adequate understanding of the aspects of the period-end financial reporting process in all audits, including audits of financial statements only. However, the new proposed standard requires the auditor only to obtain an understanding of the process, whereas Auditing Standard No. 5 requires the auditor also to evaluate that process in the audit of internal control.

Management's Risk Assessment Process

The original proposed standard required the auditor to obtain an understanding of management's risk assessment process. After reviewing those requirements, the Board has added another requirement to obtain an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks. This requirement was added so that the auditor's risk assessments can be appropriately informed by management's risk assessments and the controls intended to address the risks.

Control Activities

Existing PCAOB standards describe the auditor's responsibilities for obtaining an understanding of control activities as a two-step process: (1) obtaining an understanding of control activities in connection with understanding the other internal control components and (2) obtaining a further understanding of controls if necessary to plan the audit.[30/] The new proposed standard revises this requirement by referring to obtaining an understanding of control activities as necessary to meet the overall requirement for understanding internal control. As under existing PCAOB standards, a more extensive understanding of control activities is needed in areas in which the auditor plans to test controls.

The original proposed standard included a note stating, "For purposes of evaluating the effectiveness of internal control, the auditor's understanding of control

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[29/] AU sec. 319.49. The existing standard uses the term "financial reporting process used to prepare the entity's financial statements" but the proposed standard uses the same term as Auditing Standard No. 5.

[30/] AU sec. 319.42.

activities encompasses a broader range of accounts and disclosures than that which is normally obtained in an audit of financial statements only." Some commenters expressed concerns about whether the note was consistent with Auditing Standard No. 5 and suggested that the note be removed. The note has been removed.

Entity-level Controls

The original proposed standard on identifying and assessing risks required the auditor to obtain an understanding of the company's control environment and other components of internal control that are often entity-level controls.

Some commenters indicated that the original proposed standard did not place enough emphasis on entity-level controls and suggested that the paragraphs in Auditing Standard No. 5 related to the evaluation of entity-level controls should be included in the original proposed standard.

The requirement in Auditing Standard No. 5 to test those entity-level controls in the audit of internal control has a different objective from the objective for risk assessment procedures in general or for obtaining an understanding of internal control in particular. The Board believes that it is important for PCAOB standards to distinguish those two objectives, e.g., for auditors who are performing audits of financial statements only. On the other hand, the Board recognizes that evidence obtained while gaining an understanding of internal controls should be taken into account as part of the auditor's evaluation of the effectiveness of the controls and that obtaining an understanding of a control can be performed concurrently with testing it. Thus, the new proposed standard contains additional paragraphs discussing the relationship between obtaining an understanding of controls and testing controls, including testing entity-level controls.

8. Information Obtained in Other Engagements

The original proposed standard required the auditor to "assess whether information obtained in other engagements performed by the auditor is likely to be important in identifying risks of material misstatement." This requirement was intended to complement a requirement in the original proposed standard on audit planning and supervision to evaluate whether knowledge obtained during other engagements performed by the auditor is important to the company's financial statements and internal control and, if so, how it would affect the auditor's procedures.

RELEASE

The requirement in the original proposed standard on identifying and assessing risks carries forward the existing requirement for the engagement team to take into account relevant information obtained from other engagements performed by the firm for the company. Examples of such engagements include permissible tax services performed for the company and statutory audits of subsidiaries that are not part of the audit of the consolidated financial statements.

Some commenters suggested that the requirement should be limited to consideration of other engagements performed by the engagement partner. Some of those commenters indicated that in a large global audit, it is not practical to expect the auditor to assess information obtained on all engagements performed by the audit firm for the company. Additionally, some commenters expressed concern that the requirement in the original proposed standard could be misinterpreted to mean engagements for other clients.

The Board believes that the suggested change would weaken the new proposed standard. Limiting the consideration of information to engagements performed for the company by the engagement partner is too narrow because it omits other important information sources that are available to the engagement team. Also, limiting the consideration to engagements performed by the engagement partner is inconsistent with existing PCAOB standards.[31/] For example, AU sec 311.04 states that procedures the auditor may consider in planning an audit usually involve discussions with other firm personnel, and the standard includes the following example "Discussing matters that may affect the audit with firm personnel responsible for non-audit services to the entity." Also, paragraph 03 of AU sec. 9311, *Planning and Supervision: Auditing Interpretations of Section 311*, states –

> The auditor should consider the nature of non-audit services that have been performed. He should assess whether the services involve matters that might be expected to affect the entity's financial statements or the performance of the audit, for example, tax planning or recommendations on a cost accounting system. If the auditor decides that the performance of the non-audit services or the information likely to have been gained

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[31/] PCAOB Rule 1001, *Definitions of Terms Employed in Rules,* states that, when used in rules of the PCAOB, unless the context otherwise requires, "The term 'auditor' means both public accounting firms registered with the Public Company Accounting Oversight Board and associated persons thereof."

> from it may have implications for his audit, he should discuss the matter with personnel who rendered the services and consider how the expected conduct and scope of his audit may be affected. In some cases, the auditor may find it useful to review the pertinent portions of the work papers prepared for the non-audit engagement as an aid in determining the nature of the services rendered or the possible audit implications.

The new proposed standard requires the auditor to take into account relevant information obtained through other engagements performed by the auditor for the company. This requirement is intended to focus on the responsibility to take relevant information into account in identifying and assessing risks rather than to prescribe a particular method for obtaining that information.

9. Performing Analytical Procedures as Risk Assessment Procedures

The new proposed standard retains the requirements and direction from AU sec. 329, *Analytical Procedures,* regarding performing analytical procedures during the planning phase of the audit. Such analytical procedures are, in essence, risk assessment procedures, so the respective requirements and direction have been incorporated into the new proposed standard.

10. Conducting a Discussion among Engagement Team Members Regarding Risks of Material Misstatement

AU sec. 316 requires a discussion among engagement team members about fraud risks. The new proposed standard extends this requirement to cover risks of material misstatement due to error or fraud.

A discussion among engagement team members about the risks of material misstatement is intended to:

- Provide an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the company;
- Allow the engagement team members to exchange information about the business risks affecting the company and about how those risks could result in material misstatement due to fraud or error;

- Help engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures; and

- Provide a basis upon which engagement team members can communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

Through its inspections program, the Board has observed deficiencies relating to discussion among engagement team members regarding fraud risks,[32/] including instances in which key engagement team members did not participate. Since the engagement team discussion would be expanded to cover all risks of material misstatement, the Board evaluated whether the direction in AU sec. 316 could be enhanced to improve performance in this area. The Board decided to modify the formulation regarding the participation in the engagement team discussion to state more directly that the key engagement team members should participate in the discussion and to explain that key engagement team members include the engagement partner and all engagement team members who have significant engagement responsibilities. The term "significant engagement responsibilities" should be familiar to auditors because it is already used in AU sec. 316 regarding the appropriate assignment of engagement team members in the overall responses to fraud risks. The new proposed standard also contains additional direction regarding multi-location engagements.

The new proposed standard extends the requirements for the discussion about fraud risks by adding two discussion topics: (1) how fraud could be perpetrated or concealed by omitting or presenting incomplete disclosures and (2) the susceptibility of the financial statements to material misstatement through related party transactions. Past cases of fraudulent financial reporting have involved related party transactions and omitted or incomplete disclosures.

[32/] PCAOB Release 2007-001, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud* (January 22, 2007).

RELEASE

11. Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

AU sec. 316.24 includes a requirement to inquire of others within the entity about the existence or suspicion of fraud. That standard also presents examples of others within the entity to whom these inquiries should be directed. The original proposed standard expanded on this requirement by adding inquiries of accounting and financial personnel regarding:

- The employee's views as to whether accounting policies were appropriately or aggressively applied;
- The employee's views about the risks of fraud;
- Whether the employee has knowledge of fraud, alleged fraud, or suspected fraud affecting the company; and
- Whether the employee is aware of instance of management override of controls and the nature and circumstances of such overrides.

The original proposed standard included an additional inquiry of management regarding management's process for identifying and responding to the risks of fraud in the company, including any specific fraud risks the company has identified or account balances or disclosures for which a fraud risk is likely to exist, and the nature, extent, and frequency of management's fraud risk assessment process.

Commenters were supportive of the inquiries required of management, the audit committee, and internal audit. However, some commenters described the requirement to inquire of accounting and financial personnel as being too onerous, especially in a large multi-location entity. They were concerned that the requirement might involve an unnecessarily large number of company personnel without a corresponding benefit to the audit process. The language in the new proposed standard was revised to follow the language in AU sec. 316 more closely.

Like the original proposed standard, the new proposed standard includes an additional required inquiry of the internal auditor about whether he or she is aware of instances of management override of controls and the nature and circumstances of such overrides. Also, the new proposed standard requires the auditor to make inquiries of management and the audit committee regarding tips or complaints about the company's financial reporting. In light of research indicating that many incidents of fraud are uncovered through tips,[33/] this inquiry could provide important evidence about fraud risks.

12. Identifying and Assessing Risks of Material Misstatement

The proposed standard sets forth a process for identifying and assessing the risks of material misstatement using the information obtained from the risk assessment procedures and other relevant knowledge possessed by the auditor.[34/] This process involves:

a. Identifying risks of misstatement due to error or fraud using information obtained from the risk assessment procedures and considering the characteristics of the accounts and disclosures in the financial statements.

b. Evaluating whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions.

c. Evaluating the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected. This includes evaluating how risks at the financial statement level could affect risks at the assertion level.

d. Assessing the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements. In making this assessment, the auditor may take

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[33/] See, e.g., Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud & Abuse* (2008).

[34/] Under the new proposed standards, the auditor has a responsibility to perform risk assessment procedures that provide an appropriate basis for his or her risk assessments. The new proposed standard does not include the provision in the interim standards that allowed the auditor to assess risk at the maximum solely for efficiency reasons. Rather the auditor needs a sufficient understanding of the company and its environment, including its internal control, in order to determine the risks of material misstatement and, in turn, to design effective tests of controls and substantive procedures.

into account the planned degree of reliance on controls that the auditor plans to test, if the auditor performs tests of controls in accordance with PCAOB standards.

e. Identifying significant accounts and disclosures and their relevant assertions.

f. Determining whether any of the identified and assessed risks of material misstatement are significant risks.

Commenters on the provisions of the original proposed standard related to the identification and assessment process suggested that the order of the steps should be changed so that identification of significant accounts and disclosures should occur before the assessment of the identified risks. Under PCAOB standards, significant accounts and disclosures and their relevant assertions are identified based upon their risk characteristics rather than their size. Thus, the auditor needs to identify and assess the risks in order to identify the relevant assertions of significant accounts and disclosures in accordance with PCAOB standards.

Auditing Standard No. 5 requires the auditor to identify significant accounts and disclosures and their relevant assertions in integrated audits. Also, the existing interim standards, as amended by the PCAOB, require the auditor to perform substantive procedures for the relevant assertions of significant accounts and disclosures for all audits of financial statements, which would require the auditor to identify those accounts, disclosures, and assertions.[35/] The new proposed standard imposes a more explicit requirement to identify significant accounts and disclosures and their relevant assertions in all audits. Based on comments received on the original proposed standard, the Board believes that the new proposed standard should include the provisions from Auditing Standard No. 5 regarding the process for identifying significant accounts and disclosures and their relevant assertions because those provisions also apply to audits of financial statements. Accordingly, the new proposed standard incorporates those provisions.

Some of those commenters also suggested that the original proposed standard would be enhanced by incorporating provisions from Auditing Standard No. 5 regarding

[35/] A note to AU sec. 319.02 in the existing standards refers auditors to Auditing Standard No. 5 for direction on identifying relevant assertions.

understanding likely sources of misstatement and performing walkthroughs. The new proposed standard also includes provisions from Auditing Standard No. 5 on those topics because those provisions also apply to audits of financial statements.

The original proposed standard imposed a responsibility to determine whether any of the identified risks of material misstatement is a significant risk. Existing PCAOB standards already impose requirements for responding to significant risks.[36/] The original proposed standard defined the term "significant risks" and included provisions for identifying those risks. That definition was included in Auditing Standard No. 7, *Engagement Quality Review.*

Some commenters suggested that the definition of "significant risk" in the original proposed standard should be revised to indicate that significant risks are "identified risks" and that they are determined using the "auditor's judgment." The new proposed standard retains the definition from the original proposed standard, with slight revision. Adding the reference to the auditor's judgment is unnecessary and could be confusing because the standard does not explicitly mention professional judgment in other definitions that would necessarily involve judgment. Similarly, the reference to "identified risks" is unnecessary because it is already mentioned in the requirement for determining significant risks.

Questions

9. Does the new proposed standard adequately describe the auditor's responsibilities for performing risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of risks of material misstatement due to error or fraud and to design further audit procedures?

10. Are the auditor's responsibilities regarding the additional procedures for understanding the company and its environment in paragraph 11 clear?

11. Are the proposed requirements regarding obtaining an understanding of internal control over financial reporting appropriate in light of the auditor's responsibilities for identifying and assessing the risks of material misstatement?

[36/] See, e.g., paragraph .09 of AU 329 *Analytical Procedures*.

12. Are the proposed requirements regarding the discussion among engagement team members about risks of material misstatement appropriate given the auditor's responsibilities for identifying and assessing the risks of material misstatement?

Proposed Auditing Standard – The Auditor's Responses to the Risks of Material Misstatement

1. Background

This proposed standard establishes requirements for responding to the risks of material misstatement, including responses regarding the general conduct of the audit and responses involving audit procedures. The new proposed standard applies to integrated audits and audits of financial statements only.

2. Linking Assessed Risks and Auditor's Responses

The original proposed standard required the auditor to design and implement appropriate responses to the risks of material misstatement. Some commenters suggested that the original proposed standard should use the term "assessed risks of material misstatements" to improve the linkage between the auditor's responses and the risks assessed in accordance with the original proposed standard on identifying and assessing risks of material misstatement.

In the Board's view, obtaining sufficient appropriate evidence to support the auditor's opinion requires the auditor to adequately respond to the risks of material misstatement. Accordingly, the title and objective of the standard continues to refer to responding to the risks of material misstatement. However, the Board also recognizes that the appropriate identification and assessment of the risks of material misstatement in accordance with the proposed standard on identifying and assessing risks of material misstatement enables the auditor to effectively respond to the risks. Accordingly, the new proposed standard imposes on auditors an unconditional responsibility to design and implement responses that address the risks of material misstatement identified and assessed in accordance with the proposed standard on identifying and assessing risks of material misstatement. Also, the requirements in the new proposed standard have been revised to refer to the "assessed risk of material misstatement" when appropriate. As with the original proposed standard, noncompliance with the new proposed standard on identifying and assessing risks that leads to a failure to identify or appropriately assess a risk of material misstatement also could result in a failure to appropriately respond to the risk of material misstatement in accordance with the new proposed standard on auditor's responses.[37/]

3. Overall Responses to Risks

The original proposed standard required the auditor to respond to the risks of material misstatement through overall responses and responses involving the nature, timing, and extent of audit procedures. Overall responses relate to the general conduct of the audit, e.g., appropriate assignments and supervision of engagement team members, incorporating an element of unpredictability into the audit, and making pervasive changes to the audit. Such responses are required by AU sec. 316 in response to fraud risks, but the proposed standard would extend the requirement to apply to risks of material misstatement due to error or fraud. These responses, by their nature, are appropriate for addressing risks of material misstatement due to error or fraud.

Some commenters indicated that the language of the original proposed standard appeared to limit the element of unpredictability to fraud risks only. Existing PCAOB standards[38/] require auditors to incorporate an element of unpredictability in response to fraud risks, and the provision in the original proposed standard was intended to broaden its application to address other risks of material misstatement in addition to fraud risks. The new proposed standard indicates that the auditor should incorporate an element of unpredictability as part of the response to the risks of material misstatement, including fraud risks. However, this change to the requirement does not diminish the auditor's responsibilities for incorporating an element of unpredictability in responding to fraud risks.

Commenters also asked for more explanation about "making general changes" as an overall response as required by the original proposed standard, and they indicated that requiring "general changes" might not be appropriate in all audits. The new proposed standard requires the auditor to evaluate whether it is necessary to make pervasive changes to the audit to adequately address the risks of material misstatement.

[37/] Failure to address a risk of material misstatement also might indicate a failure to comply with the new proposed standard on identifying and assessing risks of material misstatement.

[38/] AU sec. 316.50.

RELEASE

The new proposed standard also contains examples of such pervasive changes so that auditors can determine when such changes are necessary.

Existing PCAOB standards require the auditor to apply professional skepticism as part of due care[39/] and state that the auditor's response to fraud risks involves the application of professional skepticism in gathering and evaluating audit evidence.[40/] The original proposed standard indicated that the auditor's responses to the risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence. Some commenters observed that the discussion of professional skepticism in the original proposed standard appeared to be limited to the auditor's responses rather than the entire audit. The provision in the original proposed standard was intended to emphasize the importance of professional skepticism in responding to risks of material misstatement, similar to existing PCAOB standards, rather than to limit the application to the auditor's responses only. The new proposed standard indicates that the application of professional skepticism is part of applying due professional care, which occurs throughout the audit.

4. Tests of Controls in the Audit of Internal Control

The original proposed standard contained requirements regarding tests of controls for both the audit of financial statements and the audit of internal control. As discussed previously, the Board has removed requirements that apply solely to audits of internal control from the new proposed standards. Accordingly, the requirements regarding tests of controls in an audit of internal control are not included in the new proposed standard.

It is important to note, however, that in an integrated audit, the tests of controls performed in the audit of internal control are part of the auditor's responses to the risks of material misstatement, as indicated in paragraph 9 of the new proposed standard.[41/]

[39/] AU sec. 316.13 and AU secs. 230.07-.09.

[40/] AU sec. 316.46.

[41/] Paragraph 39 of Auditing Standard No. 5 states," The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion."

To help facilitate the integration of tests of controls in an integrated audit, the new proposed standard continues to use language similar to that of Auditing Standard No. 5 when describing analogous terms and concepts relating to the testing of controls.

5. Tests of Controls and Control Risk Assessment in the Audit of Financial Statements

Requirements on When to Test Controls

Existing PCAOB standards require auditors to obtain evidence about the design and operating effectiveness of controls (a) when the auditor plans to rely on selected controls to reduce his or her substantive procedures and (b) in those limited circumstances in which the auditor cannot obtain sufficient appropriate evidence through substantive procedures alone.[42/] Thus, except in those limited circumstances, the existing standards provide auditors with flexibility to decide when or whether to test controls.

The new proposed standards do not change the requirements regarding when testing controls is necessary in audits of financial statements only. In those audits, auditors continue to have the same flexibility in deciding when or whether to test controls and reduce their substantive procedures. The new proposed standard includes additional statements that emphasize the flexibility that auditors have in making these decisions.

Some commenters suggested adding examples of situations in which auditors cannot obtain sufficient appropriate audit evidence through substantive procedures alone. The new proposed standard provides additional examples that are adapted from existing PCAOB standards.[43/]

Period of Reliance

The original proposed standard stated that when the auditor relies on controls to assess the risk of material misstatement at less than the maximum, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance.

42/ AU sec. 319.66.

43/ AU sec. 319.68.

RELEASE

Some commenters suggested that the Board provide additional explanation regarding how to apply the concept of the period of reliance, especially when the period of reliance is less than the period covered by the company's financial statements. In particular, some commenters suggested that providing a statement that evidence pertaining only to a point in time may be sufficient for the auditor's purpose, e.g., when testing controls over the entity's physical inventory counting at the period end.

The Board's view is that the concept of the period of reliance is not new. It was introduced in Auditing Standard No. 5 and discussed further in the PCAOB staff guidance, *Staff Views: An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements – Guidance for Auditors of Smaller Public Companies.* The new proposed standard provides a definition of "period of reliance" that parallels the language in paragraph B4 of Auditing Standard No. 5. The new proposed auditing standard does not include the example suggested by the commenters. That example could be misunderstood because it relates only to a point in time rather than to a period of time.

Testing Design Effectiveness in Audits of Smaller, Less Complex Companies

The "Testing Design Effectiveness" section of the original proposed standard required the auditor to test the design effectiveness of the controls selected for testing by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect error or fraud that could result in material misstatements in the financial statements.

Some commenters suggested that the discussion in the original proposed standard on testing design effectiveness of controls should include considerations for smaller, less complex companies, similar to the direction in Auditing Standard No. 5. The new proposed standard includes that additional discussion.

Timing of Tests of Controls

In connection with the removal from the original proposed standards of requirements for tests of controls in an audit of internal control, the Board reassessed the provisions regarding the timing of tests of controls in an audit of financial statements, including the provisions regarding interim testing of controls and use of evidence from past audits.

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In the discussion of interim testing of controls, the provisions in the new proposed standard regarding the evidence necessary to update the results of interim testing has been revised and expanded to highlight matters that are more specific to tests of controls in the audit of financial statements, e.g., the planned degree of reliance on the control.

In the discussion of the use of evidence from past years in the current audit, the new proposed standard retains the principle that the auditor should obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies. One commenter expressed a concern that eliminating the auditor's ability to use rotational testing of controls in audits of issuers differs from the ISAs and would be a significant, unnecessary change from current practice. The Board continues to believe that auditors should support their control risk assessments each year with current evidence. When the auditor has tested controls in past audits, the new proposed standard, allows the auditor significant flexibility to adjust the amount of evidence needed based on the relevant factors.

The original proposed standard discussed factors that affect the evidence necessary to support the current year's control risk assessments. Some commenters suggested that the original proposed standard should include all of the factors listed in paragraphs 47 and 58 of Auditing Standard No. 5. The new proposed standard includes additional factors that are relevant to the evaluation of the evidence about the effectiveness of controls needed in the current year in addition to evidence from past audits. These additional factors generally relate to the degree of reliance on the control, the risk that the control will fail to operate as designed, and the nature and amount of evidence that the auditor has already obtained regarding the effectiveness of the controls.

Control Risk Assessment

The original proposed standards described the auditor's responsibilities for assessing control risk. One commenter suggested replacing references to control risk assessment with references to assessment of the risk of material misstatement. Another commenter questioned whether to combine the provisions regarding control risk assessment with the discussion of assessing the risks of material misstatement in the original proposed standard on identifying and assessing risks of material misstatement.

The new proposed standard continues to present a separate discussion of control risk assessment in the response standard. AU sec. 319 establishes requirements for assessing control risk. Also, Auditing Standard No. 5 refers to control risk assessments in its discussion of tests of controls in the financial statement audit portion of the integrated audit. The requirements regarding assessing control risks continues to be placed in the new proposed standard after the discussion of tests of controls to emphasize that reliance on controls (i.e., assessment of control risk below the maximum level) must be supported by the results of tests of controls. While evaluating the comments on the discussion of control risk assessment, the Board determined that the proposed standard would be enhanced by expanding the discussion of control risk assessment to describe more specifically situations in which the auditor should assess control risk at the maximum level.

6. Risk of Material Misstatement and Evidence from Substantive Procedures

Existing PCAOB standards indicate that some risks of material misstatement might require responses that require more evidence from substantive procedures because of certain inherent limitations of internal control.[44/] For example, more evidence from substantive procedures ordinarily is needed for relevant assertions that have a higher susceptibility to management override or to lapses in judgment or breakdowns resulting from human failures. Recent observations from the Board's oversight activities have underscored the importance of this principle. The new proposed standard includes this principle because it is particularly relevant to the determination of the nature, timing, and extent of substantive procedures.

Like the original proposed standard, the new proposed standard contains new provisions regarding the performance of substantive procedures. The new proposed standard states the principle that substantive procedures generally provide persuasive evidence when they are designed and performed to obtain evidence that is relevant and reliable. The new proposed standard also recognizes that some type of substantive procedures, by their nature, produce more persuasive evidence than others and emphasizes that inquiry alone does not provide sufficient appropriate evidence to support a conclusion about a relevant assertion.

[44/] See, e.g., paragraph .14 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures.*

RELEASE

7. Substantive Procedures Responsive to Significant Risks

The original proposed response standard stated that for significant risks, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the risks. Existing PCAOB standards indicate that tests of details should be performed in response to significant risks.[45/]

Some commenters expressed concerns about imposing a presumptively mandatory responsibility for auditors to perform test of details in response to significant risks.

The new proposed standard retains the provision as originally proposed. The nature and importance of significant risks warrant a high level of assurance from substantive procedures to adequately address the risk. Also, analytical procedures alone are not well suited to detecting certain types of misstatements related to significant risks, including, in particular, fraud risks. For example, when fraud risks are present, management might be able to override controls to allow adjustments that result in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions.

Questions

13. Are the proposed requirements for overall responses and responses involving the nature, timing, and extent of audit procedures appropriate given the auditor's responsibility to opine with reasonable assurance about whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?

14. Does the new proposed standard clearly describe when tests of controls are necessary in an audit of financial statements only?

Proposed Auditing Standard – Evaluating Audit Results

1. Background

This proposed standard describes the auditor's responsibilities regarding the process of evaluating the results of the audit and determining whether sufficient

[45/] AU sec. 329.09

appropriate audit evidence has been obtained in order to form the opinion to be presented in the auditor's report. This new proposed standard consolidates into one auditing standard the requirements that are currently included in four separate auditing standards[46/] to highlight matters that are important to the auditor's conclusions about the financial statements and the effectiveness of internal control.

Commenters generally supported the approach to consolidate the requirements related to evaluating audit results into a single standard.

2. Objective of the Auditor

The objective of the auditor in the original proposed standard was to evaluate the results of the audit in order to form the opinion to be expressed in the auditor's report. Some commenters indicated that the objective of the original proposed standard was too broad and that the original proposed standard should present a series of objectives based upon the individual topics covered in the standard. Another commenter suggested revising the objective in the original proposed standard to include a determination of whether sufficient appropriate audit evidence has been obtained.

Providing a series of objectives would detract from the focus on those matters that are important to the opinion expressed in the auditor's report. Instead, the new proposed standard presents a single objective regarding determining whether the evidence obtained is sufficient and appropriate to support the audit opinion. This revised objective maintains the Board's intended focus on the sufficiency and appropriateness of audit evidence while evaluating audit results.

3. Definition of Misstatement

The original proposed standard defined the term "misstatement" as follows:

> A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting

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[46/] AU sec. 312, regarding evaluating audit results, including uncorrected misstatements; AU sec. 316, regarding fraud considerations that are relevant to the evaluating audit results; AU sec. 329, regarding performing the overall review; and AU sec. 326, *Evidential Matter*, regarding determining whether sufficient appropriate audit evidence has been obtained.

> framework.[47/] A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Some commenters indicated that the definition applied to "material misstatement" rather than "misstatement," and they suggested revisions to the definition.

The new proposed standard carries forward the definition of "misstatement" substantially as originally proposed. The paragraph is not a definition of "material misstatement." Rather, it emphasizes that misstatements prevent financial statements from being fairly presented in conformity with the applicable financial reporting framework, they can relate to any difference between the reported amounts in the financial statements and those that should be reported, and they can be classified into the broad categories of error and fraud. The definition in the original proposed standard is similar to the definition in an existing auditing interpretation of AU sec. 312, which states, "In the absence of materiality considerations, a misstatement causes the financial statements not to be in conformity with generally accepted accounting principles."[48/]

Some commenters expressed concern that the definition of "error" was different from the accounting standards. In light of those comments, the definition of "error" has been removed from the new proposed standard, and the definition of "misstatement" has been changed to indicate that an "error" refers to an unintentional misstatement.

4. Performing Analytical Procedures in the Overall Review

The original proposed standard has adapted the requirements in AU secs. 316 and 329 to read the financial statements and disclosures and perform analytical procedures in the overall review. These provisions impose on auditors a responsibility to

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[47/] The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

[48/] Paragraph .02 of AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312.*

read the financial statements and perform analytical procedures to (a) assess the auditor's conclusions regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement. In particular, the original proposed standard required the auditor to evaluate whether (a) evidence gathered in response to unusual or unexpected transactions, events or amounts previously identified during the audit is sufficient and (b) unusual or unexpected amounts or relationships indicate risks of material misstatement that were not previously identified.

The original proposed standard stated that the nature, timing, and extent of the analytical procedures that should be performed in the overall review depend on the nature of the company and its industry. Some commenters indicated that this statement is not consistent with the purpose of the overall review and that analytical procedures performed in the overall review generally are similar to analytical procedures performed as risk assessment procedures. The new proposed standard indicates that analytical procedures performed in the overall review may be similar to analytical procedures performed as risk assessment procedures.

The original proposed standard also required the auditor to evaluate whether management's responses to the auditor's inquiries about significant unusual or unexpected trends or relationships have been vague, implausible, or inconsistent with other audit evidence and perform procedures as necessary to address the matter. Some commenters indicated that any unusual or unexpected results should be corroborated even if management's response is not vague, implausible, or inconsistent with other audit evidence. The new proposed standard indicates that the auditor should obtain corroboration for management's explanations and should perform additional procedures as necessary if management's responses to audit inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail or precision to be useful.

5. Clearly Trivial

The original proposed standard required the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial. Some commenters suggested adding more explanation of the term "clearly trivial." The new proposed standard has been expanded to emphasize that, if auditors set a threshold for accumulating identified misstatements, that threshold must be set at a de minimis level that could not result in material misstatement of the financial statements, individually or in combination with other misstatements, after considering the possibility of further undetected misstatement.

6. Accumulating Misstatements

The original proposed standard required the auditor to accumulate misstatements based on auditor's best estimate of the total misstatements identified in the accounts and disclosures that he or she has tested (which are referred to as "likely misstatement" in existing PCAOB standards[49/]), not just the amount of misstatements specifically identified (which are referred to as "known misstatement" in existing PCAOB standards). The original proposed standard also indicated that the auditor may distinguish the misstatements among specifically identified misstatements, projected misstatements from substantive audit sampling, and misstatements related to accounting estimates.

Some commenters questioned the provision regarding using the three categories of misstatements and suggested either classifying the misstatements into the categories used in existing PCAOB standards or categorizing them in other ways. The statement in the original proposed standard regarding the three categories was intended to be helpful since the manner in which an auditor follows up on a particular misstatement may depend on the nature of the misstatement and how it was identified. However, since the auditor is required to evaluate each misstatement individually and in combination based on both quantitative and qualitative factors, the additional provision regarding categorizing the misstatements is unnecessary and is not included in the new proposed standard.

Another commenter suggested that the original proposed standard should explain the term "best estimate" and discuss how the auditor would calculate his or her best estimate. As discussed previously, the principle of accumulating the auditor's best estimate of a misstatement is not new, and requirements for determining misstatements related to such estimates already exists in PCAOB standards. For example, when errors are identified in items tested in a substantive procedure using audit sampling, existing PCAOB standards require the auditor to project the misstatements to the entire

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49/ AU sec. 312.34.

population and record the projected misstatement rather than the errors in the individual items tested on the summary of accumulated misstatements.[50/]

Some commenters also expressed concerns that "identified misstatement" was a new term and suggested that the original proposed standard should use an alternative term such as "accumulated misstatement" or "known and likely misstatement." The new proposed standard uses "identified misstatement" to refer to misstatements that are identified during the audit, and those identified misstatements that are more than clearly trivial are required to be accumulated. Because the new proposed standard requires the auditor to use his or her best estimate of the misstatement (which is how existing standards describe "likely misstatements"), it is not necessary to use the term "known and likely misstatements."

7. Considerations When Accumulated Misstatements Approach Materiality

The original proposed standard required the auditor to determine whether the overall strategy needs to be revised when the aggregate of misstatements accumulated during the audit approaches the materiality level used in planning and performing an audit. When the aggregate of misstatements approaches materiality, there likely will be greater than an appropriately low level of risk that possible undetected misstatements, combined with misstatements accumulated during the audit, could be material to the financial statements. If the auditor assesses this risk to be unacceptably high, he or she should perform additional audit procedures or determine that management has adjusted the financial statements so that the risk that financial statements are materially misstated has been reduced to an appropriately low level.

Some commenters suggested that the requirement in the original proposed standard be revised to specify that the effect on an appropriately low level of risk should be based on undetected misstatement and uncorrected misstatements instead of all the accumulated misstatements. Some commenters also suggested replacing "likely will be" with "may be" a greater than an appropriately low level of risk.

After considering these comments, the new proposed standard was revised to state that there likely will be greater than an appropriately low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements

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[50/] See, e.g., AU sec. 312.35 and paragraphs.26-.30 of AU sec. 350, *Audit Sampling.*

RELEASE

accumulated during the audit that remain uncorrected, could be material to the financial statements. The new proposed standard retains the phrase "likely will be" rather than "may be" because if the aggregate of accumulated misstatements is close to the established materiality level, the risk that the financial statements are materially misstated is likely to be unacceptably high, requiring the auditor to follow the additional steps set forth in the standard.

8. Requirement to Reassess Materiality

As discussed previously, Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*, includes a requirement to reassess materiality under certain circumstances. Some commenters indicated that the original proposed standard should specifically require the auditor to perform that reassessment of materiality before evaluating the effect of uncorrected misstatements so that the evaluation of audit results is based on the latest financial statement information. The new proposed standard states that if the reassessment of materiality as set forth in the new proposed auditing standard on consideration of materiality in planning and performing an audit results in a lower amount for the materiality level, the auditor should take into account that lower materiality level in the evaluation of uncorrected misstatements.

The original proposed standard stated that if the financial statements contain material misstatements, the auditor should issue a qualified or an adverse opinion. A commenter suggested that this requirement is not needed because it is already included in AU sec. 508, *Reports on Audited Financial Statements.* The new proposed standard replaces this requirement with a reference to AU sec. 508.

9. Evaluating Uncorrected Misstatements

The original proposed standard stated that the auditor should evaluate the uncorrected misstatements in relation to accounts and disclosures and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors. Some commenters indicated that the standard should provide additional discussion of qualitative factors. Based on these comments and observations from the Board's oversight activities, the Board believes that the new proposed standard should retain the existing provisions regarding qualitative factors in the existing auditing interpretation with some minor revisions to align the factors more closely to the terminology in the new proposed standard and to omit qualitative factors that apply only to nonissuers.[51/]

The new proposed standard also mentions examples of situations in which misstatements of relatively small amounts might be considered material for qualitative reasons.

The original proposed standard required the auditor to evaluate the effects of uncorrected misstatements detected in the prior year on the accounts and disclosures and the financial statements as a whole. Some commenters suggested that the original proposed standard should include consideration of misstatements related to the prior year that are detected in the current year. The new proposed standard requires an evaluation of the effects of both uncorrected misstatements detected in prior years and misstatements detected in the current year that relate to prior years.

Like existing PCAOB standards, the new proposed standard does not address how to evaluate the effect of prior period misstatements because that is an accounting and financial reporting matter. For example, the Securities and Exchange Commission ("SEC") staff has provided guidance in SEC Staff Accounting Bulletin ("SAB") No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements,* on the effects of prior year misstatements when quantifying misstatements in the current year financial statements. This SAB provides the SEC staff's views regarding evaluating the quantitative and qualitative factors regarding the materiality of uncorrected misstatements and evaluating the effects of prior year misstatements.

The new proposed standard states that the auditor cannot assume that an instance of error or fraud is an isolated occurrence and that the auditor should evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement. This procedure is important to inform the auditor's conclusions about whether the auditor's risk assessments remain appropriate and thus whether he or she has obtained sufficient appropriate evidence to support his or her opinion.

Similarly, the new proposed standard requires the auditor to evaluate whether identified misstatements might be indicative of fraud and, in turn, how they affect the

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[51/] AU sec. 9312.15 -.17.

auditor's evaluation of materiality and the related audit responses. This requirement is adapted from existing PCAOB standards.[52/] Like existing PCAOB standards, this requirement is phrased in terms of identified misstatements rather than accumulated misstatements because fraud of relatively small amounts can be material to the financial statements. If an auditor detects a misstatement, he or she should evaluate whether the misstatement is indicative of fraud when deciding whether a misstatement is clearly trivial and thus does not warrant including with accumulated misstatements.

10. Communication of Accumulated Misstatements to Management

The original proposed standard required the auditor to communicate accumulated misstatements to management in a timely basis to provide management an opportunity to correct them. Some commenters suggested that the original proposed standard should specifically require the auditor to request management to correct the misstatements. That requirement was retained in the new proposed standard as originally proposed because it accomplishes the objective of the requirement, which is to communicate accumulated misstatements to management. Also, the requirement suggested by the commenters is unnecessary because management has its own legal responsibilities in relation to the preparation and maintenance of the company's books, records, and financial statements.

11. Evaluating the Qualitative Aspects of the Company's Accounting Practices

The original proposed standard required the auditor to assess the qualitative aspects of the company's accounting practices, including possible bias in management's judgments regarding the amounts and disclosures in the financial statements. The purpose of this provision is to direct the auditor to evaluate potential bias in the financial statements, and if such bias exists, whether the effect of management bias in combination with the accumulated uncorrected misstatements causes the financial statements to be materially misstated, and thus not presented fairly in accordance with the applicable financial reporting framework.

Commenters generally supported the inclusion of the provisions regarding evaluation of management bias in the original proposed standard. Some commenters suggested adding a discussion of indicators of management bias and their effect on the auditor's conclusions regarding whether risk assessments and the related audit

[52/] AU sec. 316.75.

responses remain appropriate and whether the financial statements are free of material misstatement.

After considering these comments, the new proposed standard states that if the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, he or she should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. Also, the new proposed standard states that the auditor should evaluate whether the auditor's risk assessments, including, in particular, the assessment of fraud risks, and the related audit responses remain appropriate.

The new proposed standard does not cite indicators of bias because the proposed risk assessment standards already provide examples of different forms of management bias. However, the expanded discussion of bias in accounting estimates in the new proposed standard points out that bias can also result from the cumulative effect of changes in multiple accounting estimates.

Based on observations from the Board's oversight activities, the new proposed standard includes another example of management bias – the identification by management of additional adjusting entries that offset other misstatements identified by the auditor. If such misstatements are identified, the new proposed standard would require the auditor to perform procedures to determine why the misstatement was not identified previously, assess the implications on the integrity of management and the auditor's risk assessments, including fraud risk assessments, and perform additional procedures as necessary to address the risk of further undetected misstatements.

12. Misstatements Related to Accounting Estimates

In the original proposed standard, the provision regarding determination of misstatements related to accounting estimates was included in the assessment of bias in accounting estimates. Commenters suggested that the determination of misstatements discussion be moved to the discussion of accumulation of misstatements. They also suggested that the provision on misstatements be expanded to discuss both point estimates and accounting estimates outside of a reasonable range. The new proposed standard has been revised as suggested.

RELEASE

13. Evaluating Financial Statement Disclosures

The new proposed standard includes the relevant provisions from AU sec. 431, *Adequacy of Disclosure in Financial Statements,* for evaluating financial statement disclosures. These provisions were added to the new proposed standard because of the importance of disclosures to the fair presentation of financial statements.

14. Assessment of Fraud Risks

The original proposed standard required the auditor to evaluate whether the accumulated results of auditing procedures and other observations affect the auditor's assessment of fraud risk made earlier in the audit. This evaluation could provide additional insight regarding the risks of material misstatement due to fraud and the potential need to perform additional procedures to support the opinion to be expressed in the auditor's report. Some commenters suggested replacing the assessment of fraud risk made "earlier in the audit" with "throughout the audit" as fraud risks are considered throughout the audit. Commenters also suggested moving the statement that the auditor's assessment of fraud risks should be ongoing throughout the audit to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*. The new proposed standards have been revised as suggested.

15. Evaluating the Sufficiency and Appropriateness of Audit Evidence

The original proposed standard required the auditor to conclude on whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements. The original proposed standard also presented a list of factors that are relevant to the auditor's conclusions on whether sufficient appropriate audit evidence has been obtained. Commenters observed that the original proposed standard required the auditor to evaluate all of the listed factors, and they suggested that the requirement be changed to allow the auditor to select the factors to be evaluated. The Board believes that the consideration of the listed factors is essential to reaching an informed conclusion about whether sufficient appropriate audit evidence has been obtained, so the new proposed standard retains the requirement as originally proposed.

The requirements regarding situations in which the auditor has not obtained sufficient appropriate audit evidence have been expanded in the new proposed standard to include situations in which the auditor has substantial doubts about a relevant assertion. This additional provision is adapted from existing PCAOB standards.[53/]

16. Evaluating the Results of the Audit of Internal Control

The original proposed standard included a section relating to evaluating audit results in the audit of internal control. In connection with the aforementioned decision to remove from the proposed risk assessment standards provisions relating only to the audit of internal control, the new proposed standard contains only a paragraph that references Auditing Standard No. 5 for the requirements on evaluating the results of the audit of internal control.

Questions

15. Does the new proposed standard clearly describe the auditor's responsibilities for accumulating and evaluating misstatements?

16. Does the new proposed standard appropriately describe the auditor's responsibilities for evaluating the presentation of the financial statements, including evaluating bias, in light of the auditor's responsibility to opine with reasonable assurance on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?

Proposed Auditing Standard – Audit Evidence

1. Background

This proposed standard sets forth the auditor's responsibilities regarding designing and performing audit procedures to obtain sufficient appropriate evidence to support the opinion(s) in the auditor's report and discusses methods for selecting items for testing.

2. Nature of Audit Evidence

The original proposed standard stated that audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in

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[53/] AU sec. 326.25.

arriving at the conclusion on which the audit opinion is based. Audit evidence includes both corroborating and conflicting information. Some commenters suggested that the original proposed standard should indicate that information obtained from previous audits may be used as evidence for the current period audit and that audit evidence includes information contained in the accounting records underlying the financial statements and other information.

The new proposed standard does not include the additional language suggested by the commenters. Such statements are unnecessary because the original proposed standard already stated that evidence encompasses all of the information used by the auditor. Furthermore, including the suggested statements about using information from prior audits or information in the accounting records could result in auditors overlooking the respective requirements in other PCAOB standards for using that information.

3. Objective

The auditor's objective in the original proposed standard was to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report. Some commenters indicated that the objective of the proposed standard was too broad because it related to the entire audit, and they suggested that the objective should be revised to focus on planning and performing audit procedures to obtain sufficient appropriate audit evidence. The revised objective in the new proposed standard acknowledges the auditor's responsibility to plan and perform the audit to obtain sufficient appropriate audit evidence to support the opinion expressed in the auditor's report.

4. Sufficient Appropriate Audit Evidence

The new proposed standard requires the auditor to design and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion, and this requirement applies to both the audit of financial statements and the audit of internal control. The new proposed standard explains the meaning of sufficient and appropriate as used in the phrase "sufficient appropriate audit evidence." The new proposed standard also sets forth principles for evaluating the sufficiency and appropriateness of audit evidence, which auditors should take into account in determining the necessary nature, timing, and extent of their audit procedures.

RELEASE

The original proposed standard stated that, to be appropriate, audit evidence must be both relevant and reliable. Some commenters indicated that this statement did not acknowledge the degree of relevance and reliability of audit evidence. The new proposed standard clarifies that the audit evidence should be sufficiently relevant and reliable to support the auditor's conclusions about the subject of the audit procedure.

5. Financial Statement Assertions

Financial statement assertions are an important consideration for audits performed in accordance with PCAOB standards. For example, PCAOB standards require auditors to perform substantive procedures for relevant assertions in audits of financial statements and to obtain evidence about the design and operating effectiveness of controls over relevant assertions in audits of internal control.

This original proposed standard retained the five categories of financial statement assertions in AU sec. 326 and Auditing Standard No. 5, and allowed auditors to use categories of assertions that differ from the assertions listed in this standard under specified conditions. Some commenters questioned whether the language in the original proposed standard was intended to imply that the assertions used for the financial statement audit might differ from those for the audit of internal control.

The assertions used by the auditor should be the same for the audit of the financial statements and the audit of internal control. The new proposed standard has been revised to present a single principle that applies to audits of financial statements and to audits of internal control over financial reporting.

6. Selecting Items for Testing

The proposed standard contains a section on selecting items for testing. Currently, this topic is discussed in an auditing interpretation to AU sec. 350, *Audit Sampling.*[54/] Like the auditing interpretation, the original proposed standard stated that application of an audit procedure to all items in an account or to specific items selected because of their characteristics does not constitute audit sampling, and the results of the procedure cannot be projected to the entire population. Some commenters suggested that the original proposed standard should state that selective examination of the specific items, particularly if those items are selected based on the auditor's belief

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54/ AU sec. 9350, *Audit Sampling: Auditing Interpretations of AU sec. 350.*

that they are more likely to contain a misstatement, may provide the auditor with some audit evidence concerning the remainder of the population.

The new proposed standard does not include the suggested statement. In the Board's view, the auditor cannot obtain sufficient appropriate audit evidence to reach a conclusion about one group of items in a population by examining dissimilar items in the population. Adding the suggested statement might result in misunderstandings that, in turn, lead to inadequate testing or incorrect conclusions about the account being tested.

Question

17. Does the new proposed standard describe clearly how the auditor should determine the financial statement assertions to use for both integrated audits and audits of financial statements only?

Proposed Amendments to PCAOB Standards

Proposed Amendments to Auditing Standard No. 3

In the release accompanying the original proposed standards, the Board sought comment on the need for specific documentation requirements regarding the risk assessment procedures. Responses from commenters were mixed. Two commenters supported adding specific documentation requirements, four indicated that the existing requirements in Auditing Standard No. 3 are adequate, and one commenter was ambivalent.

After consideration of these comments and additional analysis of the new proposed standards, the Board is proposing certain amendments to Auditing Standard No. 3 to (a) specify certain required documentation regarding the auditor's risk assessments and related responses; (b) align certain terms and provisions of the standard with the new proposed standards;[55/] and (c) incorporate the principles for

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[55/] See the proposed amendments to paragraphs 9, 12, and 19.

documentation of disagreements among engagement team members,[56] as discussed previously.[57]

For example, the proposed amendments indicate that the auditor's documentation should include the following:

a. A summary of the identified risks of misstatement and the auditor's assessment of risks of material misstatement at the financial statement and assertion levels; and

b. The auditor's responses to the risks of material misstatement, including a summary of the linkage of the responses to those risks.

Also, the requirements regarding documentation of significant findings or issues and related matters would be expanded by a proposed amendment to include documentation regarding the significant risks identified and the results of the auditing procedures performed in response to those risks.

The proposed new documentation requirements are intended to enhance the auditor's ability to link identified and assessed risks to appropriate responses and could help reviewers understand the areas of greater risk and the auditor's responses to those risks. In addition to these new proposed requirements, the auditor would continue to be responsible for preparing documentation as required by other provisions of Auditing Standard No. 3, e.g., to demonstrate that the engagement complied with the standards of the PCAOB.[58]

Proposed Amendments to Auditing Standard No. 4

The proposed amendments to Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist,* are limited to changing the word "competent" to "appropriate," when that word is used in reference to audit evidence and updating references to auditing standards that are being superseded or amended.

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[56] See the proposed amendments to paragraph 12.d.

[57] See the prior discussion of the proposed standard on audit planning and supervision.

[58] Paragraph 5.a. of Auditing Standard No. 3.

RELEASE

Proposed Amendments to Auditing Standard No. 5

The proposed amendments to Auditing Standard No. 5 are limited to changing the phrase "any assistants" to "the members of the engagement team," changing the word "competent" to "appropriate" when that word is used in reference to audit evidence, and updating references to auditing standards that are being superseded or amended.

As discussed previously, some commenters observed that, on the one hand, the original proposed standards did not include certain essential risk assessment procedures from Auditing Standard No. 5 and, on the other hand, the original proposed standards contained certain requirements regarding testing controls and evaluating audit results in the audit of internal control that overlapped or duplicated requirements in Auditing Standard No. 5. Those commenters suggested incorporating into the risk assessment standards all of the Auditing Standard No. 5 requirements regarding risk assessment procedures and removing from the risk assessment standards all requirements for testing controls and evaluating audit results that applied only to the audit of internal control.

The new proposed standards incorporate the Auditing Standard No. 5 requirements related to identifying and assessing risks of material misstatement and do not include requirements related only to the audit of internal control. The Board does not propose to remove the requirements regarding risk assessment procedures from Auditing Standard No. 5 because those requirements are important to understanding the other provisions of Auditing Standard No. 5.

Proposed Amendments to Auditing Standard No. 6

The proposed amendments to Auditing Standard No. 6, *Evaluating Consistency of Financial Statements,* are limited to updating a reference to a standard that is being superseded and removing a footnote stating that the term "error" as used in Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("SFAS No. 154"), is equivalent to "misstatement" as used in the auditing standards. This technical change is proposed because the footnote regarding misstatements in Auditing Standard No. 6 refers to the SFAS No. 154, whereas the definition of "misstatement" in the new proposed standard on evaluating audit results is neutral regarding the financial reporting framework. However, this technical change does not alter the fact that an error under accounting standards generally accepted in the United States is a misstatement under the new proposed standard.

RELEASE

Proposed Amendments to Auditing Standard No. 7

The proposed amendments to Auditing Standard No. 7 would update footnotes 3 and 10 to replace a reference to an existing interim standard that would be superseded and update the definitions of the terms "engagement partner" and "significant risk," respectively, to conform to the definitions in the new proposed standards.

Proposed Amendments to Interim Auditing Standards

Superseded Sections

The new proposed standards would supersede the following sections of PCAOB interim auditing standards:

- AU sec. 311, *Planning and Supervision*
- AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*
- AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date*
- AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*
- AU sec. 326, *Evidential Matter*
- AU sec. 431, *Adequacy of Disclosure in Financial Statements*

Similarly, the auditing interpretations of AU secs. 311, 312, and 350 have been incorporated into the new proposed standards and thus would be superseded. The auditing interpretations to AU sec. 326, except for Interpretation No. 2 (AU sec. 9326.06-.23), also would be superseded.[59/]

The original proposed standards and amendments to PCAOB standards did not include superseding AU sec. 431. The essential provisions of AU sec. 431 regarding evaluating disclosures have been incorporated into the new proposed standard on

[59/] Interpretation No. 2 relates in part to AU sec. 336, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments,* and it will be evaluated in connection with standards-setting projects related to those standards.

evaluating audit results, so AU sec. 431 would be superseded by the new proposed standard.

AU sec. 316, Consideration of Fraud in a Financial Statement Audit

As discussed previously, the relevant requirements and direction regarding identifying and assessing fraud risks, responding to fraud risks and evaluating audit results have been incorporated into the new proposed standards. The remaining portions of AU sec. 316 describe important principles regarding the auditor's responsibility with respect to fraud and more detailed requirements and direction regarding the auditor's responses to fraud risks.

The relevant requirements and direction regarding identifying and assessing fraud risks, principally AU sec. 316.14-.45; responding to fraud risks, principally AU sec. 316.46-.50; and evaluating audit results, principally, AU secs. 316.68-.78; have been incorporated into the new proposed standards. The remaining portions of AU sec. 316 describe important principles regarding the auditor's responsibility with respect to fraud and more detailed requirements and direction regarding the auditor's responses to fraud risks. The amendments to AU sec. 316 include an overview of the auditor's consideration of fraud and, where applicable, references to the appropriate requirements and direction in the new proposed standards.

AU sec. 329, Analytical Procedures

As with the original proposal, the discussion in AU sec. 329 regarding analytical procedures performed during audit planning, principally paragraphs AU secs. 329.03, and 329.06-.08, are incorporated into Proposed Auditing Standard, I*dentifying and Assessing Risks of Material Misstatement*. Similarly, the requirements and direction regarding analytical procedures in the overall review, principally AU secs. 329.23-.24, are incorporated into Proposed Auditing Standard, *Evaluating Audit Results*. The remaining portion of this standard relates to analytical procedures performed as substantive procedures. Therefore, this standard would be re-titled as *Substantive Analytical Procedures,* which more accurately reflects the content of the amended standard.

A standard that focuses solely on substantive analytical procedures would highlight more clearly the requirements that apply to analytical procedures performed for that purpose. The Board has observed instances in which auditors performed substantive procedures to test accounts without meeting the requirements in AU sec. 329 for substantive analytical procedures.[60/]

AU sec. 350, Audit Sampling

The discussion in AU sec. 350 regarding audit risk and tolerable misstatement has been amended to align more closely with the new proposed standards.

Some commenters on the original proposal expressed concerns about description of the relationship between concept of tolerable misstatement as described in AU sec. 350 and in the new proposed standard on consideration of materiality in planning and performing an audit. The proposed amendments contain a new paragraph that explains that relationship in more detail.

The original proposal included amendments to AU secs. 350.23 and 350.38, which would explain more specifically how the principles in the standard for determining sample sizes when nonstatistical sampling approaches are used. Some commenters expressed concerns that the proposed amendments would have required auditors who use nonstatistical sampling methods to compute sample sizes under both statistical and nonstatistical methods to demonstrate that the sample size under the nonstatistical method equaled or exceeded sample size under a statistical method. The proposed amendments are not intended to require auditors to compute sample sizes using statistical methods in all instances to demonstrate compliance with the requirements. For example, the use of a nonstatistical sampling method that is adapted appropriately from a statistical sampling method also could demonstrate compliance. Accordingly, these amendments are retained as originally proposed.

Other Amendments to the Interim Auditing Standards

For the following interim auditing standards, the proposed amendments are limited to conforming terminology to the new proposed standards and updating references to auditing standards that are being superseded or amended:

- AU sec. 110, *Responsibilities and Functions of the Independent Auditor*
- AU sec. 150, *Generally Accepted Auditing Standards*

[60/] See, e.g., PCAOB Release 2007-010, *Report on the PCAOB's 2004, 2005 and 2006 Inspections of Domestic Triennially Inspected Firms* (October 22, 2007).

- AU sec. 230, *Due Professional Care in the Performance of Work*
- AU sec. 310, *Appointment of the Independent Auditor*
- AU sec. 315, *Communications between Predecessor and Successor Auditors*
- AU sec. 317, *Illegal Acts by Clients*
- AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.
- AU sec. 324, *Service Organizations*
- AU sec. 328, *Auditing Fair Value Measurements and Disclosures*
- AU sec. 330, *The Confirmation Process*
- AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*
- AU sec. 333, *Management Representations*
- AU sec. 334, *Related Parties,* and AU sec. 9334, *Related Parties: Auditing Interpretations of Section 334*
- AU sec. 336, *Using the Work of a Specialist,* and AU sec. 9336, *Using the Work of a Specialist: Auditing Interpretation of Section 336*
- AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
- AU sec. 342, *Auditing Accounting Estimates*, and AU sec. 9342, *Auditing Accounting Estimates: Auditing Interpretation of Section 342*
- AU sec. 411, *The Meaning of Presented Fairly in Conformity With Generally Accepted Accounting Principles*

- AU sec. 508, *Reports on Audited Financial Statements,* and AU sec. 9508, *Reports on Audited Financial Statements: Auditing Interpretations of Section 508*

- AU sec. 530, *Dating of the Independent Auditor's Report*

- AU sec. 623, *Special Reports*

- AU sec. 722, *Interim Financial Information*

The Board also is proposing certain amendments to paragraph .12 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors,* to align that standard with related proposed amendments to Auditing Standard No. 3, which were discussed previously. Also, footnote 4 to paragraph .16 of AU sec. 9543*, Part of Audit Performed by Other Independent Auditors: Auditing Interpretation of Section 543,* was deleted because it refers to an interim standard that is being superseded.

Proposed Amendments to Interim Ethics Standards

In the interim ethics standard, ET sec. 102, *Integrity and Objectivity,* the proposed amendments are limited to updating references to auditing standards that are being superseded or amended.

<u>Question</u>

18. Are there provisions in the to-be-superseded standards that should be retained?

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APPENDIX 10

Comparison of the Objectives and Requirements of Proposed Auditing Standards to the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

This appendix discusses certain differences between the objectives and requirements of the accompanying proposed standards in this release and the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and analogous proposed or adopted standards of the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA").[1/] This analysis does not cover the application and explanatory material in the IAASB standards or proposed ASB standards.[2/]

This appendix is provided for informational purposes only. It is not a substitute for the proposed standards themselves, which are presented in Appendices 1-7 of this release and discussed further in Appendix 9.

This analysis may not represent the views of the IAASB or ASB regarding the interpretation of their standards.

[1/] In October 2009, the ASB approved as final standards its redrafted risk assessment standards as part of its clarity project. However, the ASB has not yet published those final standards.

[2/] Paragraph A59 of International Standard on Auditing ("ISA") 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,* indicates that the Application and Other Explanatory Material section of the ISAs "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA." Paragraph A63 of the SAS, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards,* states that although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU section."

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Proposed Auditing Standard – Audit Risk

As discussed in Appendix 9, the proposed standard describes the components of audit risk.

Analogous discussions of the components of audit risk are included in the IAASB's International Standard on Auditing ("ISA") 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* and the ASB's Statement on Auditing Standards ("SAS"), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards,* respectively.

1. Basis for auditor's opinion

PCAOB

The proposed standard contains a requirement to form an appropriate basis for expressing an opinion on the financial statements the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.[3/]

The proposed standard clarifies that obtaining sufficient appropriate audit evidence is part of applying professional due care. See further discussion in Appendix 9.

IAASB and ASB

The ISA contains the following requirement, and the SAS has a similar requirement –

> To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

[3/] AU sec. 110, *Responsibilities and Functions of the Independent Auditor,* and AU sec. 230, *Due Professional Care in the Performance of Work,* provide further discussion of reasonable assurance.

RELEASE

2. Detection risk and substantive tests

PCAOB

The proposed standard contains a requirement that states, as the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase.[4]

While detection risk is reduced by performing audit procedures other than substantive procedures, the proposed standard carries forward a responsibility for the auditor to perform substantive procedures for significant accounts and disclosures that are sufficient to provide reasonable assurance of detecting misstatements that would result in material misstatements of the financial statements. See further discussion in Appendix 9.

IAASB and ASB

The ISA and proposed SAS do not include a similar requirement.

Proposed Auditing Standard – Audit Planning and Supervision

In this section, the analogous IAASB and ASB standards are, unless indicated otherwise, ISA 300, *Planning an Audit of Financial Statements,* and proposed SAS, *Planning an Audit (Redrafted),* respectively.

1. Planning the audit

PCAOB

The proposed standard contains a requirement to properly plan the audit. This requirement is consistent with the first standard of fieldwork in AU sec. 150, *Generally Accepted Auditing Standards.*

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[4] Paragraphs .81 and .82 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit,* contain a similar requirement.

RELEASE

IAASB and ASB

The ISA and proposed SAS do not include a similar requirement, although it is referenced in the objective of the standards.

2. Audit strategy and planning activities

PCAOB

The proposed standard contains requirements for the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan. When developing the audit strategy and audit plan, the proposed standard requires the auditor to evaluate whether certain matters specified in the standard are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures particularly the audit plan and audit strategy. As discussed in Appendix 9, these matters are adapted from existing PCAOB standards and are important for both the audit of financial statements and an audit of internal control over financial reporting.

IAASB and ASB

The ISA and the proposed SAS also require the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan. However, these standards require the auditor to identify characteristics of the engagement that define its scope, and they do not provide specific matters that the auditor needs to evaluate as part of that process.

3. Multi-location engagements

PCAOB

The proposed standard states that the auditor should determine the extent to which auditing procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit. The proposed standard also provides a list of factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures.

The proposed standard adapted the requirements from existing PCAOB standards while refining the provisions regarding consideration of risk for individual locations.[5/] See further discussion in Appendix 9.

The provisions in the proposed standard are applicable to all multi-location audits, not just group audits.

IAASB and ASB

ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors) and the proposed SAS, Audits of Group Financial Statements (Including the Work of Component Auditors),* apply to audits of financial statements that include financial information from more than one component. These standards also describe the scope of audit procedures to be performed at individual components, depending upon, among other things, whether the components are significant components as described in the standards.

4. Supervision

PCAOB

The proposed standard specifies that the engagement partner is responsible for supervising other engagement team members, but may seek assistance from appropriate engagement team members. The proposed standard also requires the auditor to properly supervise the members of the engagement team, discusses the elements of proper supervision, and includes factors that affect the level of supervision.

[5/] See AU sec. 312, *Audit Risk and Materiality in Conducting an Audit,* and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*.

RELEASE

These requirements are adapted from existing PCAOB standards and explicitly describe the engagement partner's responsibility.[6/]

IAASB and ASB

The ISA and the proposed SAS require the auditor to plan the nature, timing, and extent of direction and supervision of engagement team members and review their work. ISA 220, *Quality Control for an Audit of Financial Statements,* and the proposed SAS, *Quality Control for an Audit of Financial Statements,* require the engagement partner to "take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements and for the auditor's report being appropriate in the circumstances."

Proposed Auditing Standard – Consideration of Materiality in Planning and Performing an Audit

In this section, the analogous IAASB and ASB standards are ISA 320, *Materiality in Planning and Performing an Audit*, and proposed SAS, *Materiality in Planning and Performing an Audit (Redrafted)*, respectively.

1. Definition of Materiality

PCAOB

The proposed standard requires the auditor to establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances, including consideration of the company's earnings and other relevant factors. As discussed in Appendix 9, the requirement in the proposed standard is based on the concept of materiality that is articulated by the Supreme Court of the United States in interpreting the federal securities laws.

IAASB and ASB

The ISA states, "When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole." The proposed SAS has a similar requirement.

[6/] See AU sec. 311, *Planning and Supervision,* and Auditing Standard No. 5.

RELEASE

2. Determining Tolerable Misstatement[7/]

PCAOB

The proposed standard contains a requirement to take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods when determining tolerable misstatement and planning and performing audit procedures. This requirement is adapted from existing PCAOB standards.[8/]

IAASB and ASB

The ISA and proposed SAS require the auditor to determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures.

3. Multi-Location Materiality Determination

PCAOB

The proposed standard discusses materiality for multi-location engagements in the context of an audit of consolidated financial statements of a company that has multiple locations or business units. The proposed standard requires the auditor to establish the materiality level to be used in performing audit procedures at the business units or locations at an amount that is generally less than the materiality level for the consolidated financial statements as a whole. This requirement is intended to allow for the risk of undetected or uncorrected misstatements in the business units or locations exceeding the materiality level at the consolidated financial statements level. Additionally, the proposed standard establishes a principle for determining how to establish materiality for a particular location or business unit. As discussed earlier in this Appendix, the provisions in the proposed standard are applicable to all multi-location audits, not just group audits.

7/ The ISA and proposed SAS use the term "performance materiality." The proposed standard retains the term "tolerable misstatement," which is used in existing PCAOB standards. Appendix 9 discusses the difference in terminology.

8/ AU sec. 312.23.

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IAASB

The ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*, requires the group engagement team to determine, among other things, component materiality. The ISA states –

> Component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit. To reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole, component materiality shall be lower than materiality for the group financial statements as a whole.

ASB

Proposed SAS, *Audits of Group Financial Statements (Including the Work of Component Auditors)*, requires the group engagement team to determine among other things, component materiality. The proposed SAS states –

> Component materiality for those components on which an audit or other specified audit procedures will be performed. To reduce the risk that the aggregate of detected and undetected misstatements in the group financial statements exceeds the materiality for the group financial statements as a whole, component materiality should be lower than the materiality for the group financial statements as a whole.

Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement

In this section, the analogous IAASB standards are ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment,* and ISA 240, *The Auditor's Responsibilities Relating to Fraud In An Audit of Financial Statements* (collectively referred to in this section as "the ISAs"). The analogous ASB standards are proposed SAS, *Understanding the Entity and its Environment and Assessing Risk* (Redrafted) and proposed SAS, *Consideration of Fraud In A Financial Statement Audit* (Redrafted) *(*collectively referred to in this section as "the proposed SASs").

RELEASE

1. Performing Risk Assessment Procedures

PCAOB

The proposed standard includes a requirement to perform risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of the risks of material misstatement due to error or fraud and to design further audit procedures. In a risk-based audit, the auditor's testing of accounts and disclosures is directed toward the areas of greatest risk. This requirement is intended to establish principles for determining the sufficiency of risk assessment procedures.

IAASB and ASB

The ISAs state –

> The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

The proposed SASs have similar requirements.

2. Obtaining an Understanding of the Company and its Environment

PCAOB

The proposed standard includes a requirement to evaluate, while obtaining an understanding of the company, whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement. This requirement is adapted from existing PCAOB standards, which recognize that financial reporting risks can arise due to circumstances such as changes in operating environment; new personnel; new or revamped information systems; rapid growth; new technology; new business models, products, or activities;

corporate restructurings; expanded foreign operations; and new accounting pronouncements.[9/]

IAASB and ASB

The ISAs and proposed SASs do not include a similar requirement.

3. Nature of the Company

PCAOB

As part of obtaining an understanding of the nature of the company, the proposed standard would require the auditor to consider performing certain procedures, such as reading public information about the company, observing or reading transcripts of earnings calls, obtaining an understanding of compensation arrangements with senior management, and obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders.

IAASB and ASB

The ISAs and proposed SASs do not include a similar requirement.

4. Obtaining an Understanding of Internal Control Over Financial Reporting

PCAOB

The proposed standard requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements; (b) assess the factors that affect the risks of material misstatement; and (c) design further auditor procedures. Like existing PCAOB standards, the proposed standard sets forth the principle for determining the sufficiency of the understanding of internal control over financial reporting.[10/]

[9/] AU sec. 319.38.

[10/] AU sec. 319.25.

IAASB and ASB

The ISAs and the proposed SASs require the auditor to obtain an understanding of internal control relevant to the audit.

5. Control Environment

PCAOB

The proposed standard contains a requirement for the auditor to assess the following matters as part of obtaining an understanding of the control environment:

(a) Whether management's philosophy and operating style promote effective internal control over financial reporting;

(b) Whether sound integrity and ethical values, particularly of top management, are developed and understood; and

(c) Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

This requirement is aligned with the requirements in Auditing Standard No. 5 for evaluating the control environment. See appendix 9 for additional details.

Because of the importance of the control environment to effective internal control over financial reporting, the proposed standard includes a new requirement that indicates that if the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor.

IAASB and ASB

The ISAs state –

The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

(a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and

(b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment.

The proposed SASs include similar requirements.

6. Understanding the Company's Risk Assessment Process

PCAOB

The proposed standard requires the auditor to obtain an understanding of management's process for (a) identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud; (b) assessing the likelihood and significance of misstatements resulting from those risks; and (c) deciding about actions to address those risks. Obtaining an understanding also includes obtaining an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.

The proposed standard does not prescribe specific audit procedures based on the level of formality or documentation of a company's risk assessment component of internal control over financial reporting.

IAASB and ASB

The requirements in the ISAs and the proposed SASs are similar to those in the proposed standard for the auditor to obtain an understanding of the company's risk assessment process as part of obtaining an understanding of internal control. The ISAs and the proposed SASs include additional requirements for situations in which the company has no formal risk assessment process or a lack of documentation regarding the process.

7. Relationship of Understanding of Internal Control Over Financial Reporting to Tests of Controls

PCAOB

The proposed standard includes a requirement that the auditor should take into account the evidence obtained from understanding internal control when assessing control risk and, in the audit of internal control over financial reporting, forming conclusions about the effectiveness of controls. The proposed standard also includes a requirement to take into account the evidence obtained from understanding internal control when determining the nature, timing, and extent of procedures necessary to support the auditor's conclusions about the effectiveness of entity-level controls in the audit of internal control over financial reporting. The requirements related to performing the audit of internal control over financial reporting are unique PCAOB standards.

IAASB and ASB

The ISAs and proposed SASs do not include similar requirements.

8. Considering Information from the Client Acceptance and Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements

PCAOB

The proposed standard includes a requirement to evaluate whether information obtained during a review of interim financial information in accordance with AU sec. 722, *Interim Financial Information,* is relevant to identifying risks of material misstatement in the year-end audit. This requirement is unique to the PCAOB standards.

The proposed standard also states that if the auditor has obtained other information relevant to identifying risks of material misstatement through other engagements performed for the company, the auditor should take that into account in identifying risks of material misstatement. This provision is adapted from existing PCAOB standards[11/] and is discussed in detail in Appendix 9.

IAASB and *ASB*

The ISAs state, "if the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to the identifying risks of material misstatement."

[11/] Paragraph .03 of AU sec. 9311, *Planning and Supervision: Auditing Interpretation of Section 311*.

RELEASE

The proposed SASs include a similar requirement.

9. Performing Analytical Procedures

PCAOB

The proposed standard contains a requirement, which is adapted from existing PCAOB standards, to perform analytical procedures regarding revenue as risk assessment procedures with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement, including material misstatement due to fraud.[12/]

The proposed standard also includes a requirement to take into account analytical procedures performed in accordance with AU sec. 722 when designing and applying analytical procedures as risk assessment procedures. This requirement is unique to PCAOB standards.

IAASB

The ISAs state –

> The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

ASB

The proposed SASs state –

> Based on analytical procedures performed as part of risk assessment procedures, the auditor should evaluate whether unusual or unexpected relationships that have been identified indicate risks of material misstatements due to fraud. To the extent not already included, the analytical procedures and evaluation thereof should include procedures relating to revenue accounts.

[12/] Paragraph .29 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*

RELEASE

10. Discussion of the Potential for Material Misstatement Due to Fraud

PCAOB

The proposed standard carries forward a requirement from existing PCAOB standards for discussion among the key engagement team members of certain matters regarding fraud, including how and where the company's financial statements might be susceptible to material misstatement due to fraud, known fraud risk factors, the risk of management override of controls, and possible responses to fraud risks.[13/] The proposed standard also includes a requirement to emphasize certain matters to all engagement team members, including the need to be alert for information or other conditions that might affect the assessment of fraud risks, and actions to be taken if information or other conditions indicate a material misstatement due to fraud might have occurred. These requirements establish a principle for determining the persons who should participate in the discussion among the engagement team members as well as what should be discussed. The ISAs do not include requirements regarding the specific matters to be discussed among the engagement team members.

IAASB

ISA 315 states –

> The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion.

ISA 240 states –

> ISA 315 requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to engagement team members not involved in the discussion.[14] This discussion shall place particular emphasis on how and

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13/ AU secs. 316.14-.17.

14/ Paragraph 10 of ISA 315.

where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity.

ASB

The proposed SASs include requirements similar to the proposed PCAOB standard regarding the matters to be discussed among engagement team members.

11. Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

PCAOB

The proposed standard requires the auditor to make inquiries of management and the audit committee regarding tips or complaints about the company's financial reporting. In light of research indicating that many incidents of fraud are uncovered through tips,[15/] this inquiry could provide important evidence about risks of material misstatement due to fraud.

IAASB and ASB

The ISAs and the proposed SASs do not have a similar requirement.

12. Identifying Significant Accounts and Disclosures and Relevant Assertions

PCAOB

The proposed standard specifically requires the auditor to identify significant accounts and disclosures and their relevant assertions in all audits as part of assessing risks. This requirement is adapted from existing PCAOB standards[16/], and it is relevant to integrated audits and to audits of financial statements only, as discussed in Appendix 9.

[15/] See, e.g., Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud & Abuse* (2008).

[16/] AU sec. 319.02 and paragraphs 28-33 of Auditing Standard No. 5.

RELEASE

IAASB

The ISAs state, "The auditor shall identify and assess the risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures."

ASB

The proposed SASs state, "To provide a basis for designing and performing further audit procedures, the auditor should identify and assess the risks of material misstatement at the relevant assertion level related to each material class of transactions, account balance, and disclosure."

13. Understanding Likely Sources of Misstatement

PCAOB

The proposed standard incorporates the provisions from Auditing Standard No. 5 regarding understanding likely sources of misstatements because these provisions also apply to financial statement audits. See further discussion in Appendix 9.

IAASB and ASB

The ISAs and proposed SASs do not have a similar requirement.

Proposed Auditing Standard – The Auditor's Responses to the Risk of Material Misstatement

In this section, the analogous IAASB standards are ISA 330, *The Auditor's Responses to Assessed Risks*, and ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* (collectively referred to in this section as "the ISAs". The analogous ASB standards are the proposed SASs, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (Redrafted)*, and the proposed SAS, *Consideration of Fraud in an Financial Statement Audit* (collectively referred to in this section as "the proposed SASs").

RELEASE

1. Objectives

PCAOB

The objective of the auditor in the proposed standard is "to address the risks of material misstatement through appropriate overall audit responses and audit procedures." The objective in the proposed standard emphasizes that the auditor's responses must be sufficient to address the risks of material misstatements.

IAASB and ASB

The objective of the auditor in ISA 330 and the proposed SASs is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

2. Overall Responses

PCAOB

The proposed standard contains a requirement to design and implement overall responses in certain areas (e.g., making appropriate assignments of specific engagement responsibilities, providing an appropriate level of supervision, incorporating elements of unpredictability in selecting auditing procedures, and evaluating the company's selection and application of significant accounting principles) to address the risks of material misstatement at the financial statement level and the significant account or disclosure level. Such responses are required by AU sec. 316 in response to fraud risks, but the proposed standard would extend the requirement to apply to risks of material misstatement due to error or fraud. These responses, by their nature, are appropriate for addressing risks of material misstatement due to error or fraud.

IAASB and ASB

The ISAs and proposed SASs include requirements to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level and requirements for particular types of responses to the risks of material misstatement due to fraud at the financial statement level.

RELEASE

3. Application of Professional Skepticism

PCAOB

The proposed standard adapted the existing requirements in AU sec. 316 regarding applying professional skepticism and extended the requirements to all risks of material misstatements due to error or fraud. The proposed standard also discusses how the auditor can apply professional skepticism in response to fraud risks.

The existing requirement in AU sec. 230, *Due Professional Care in the Performance of Work,* requires the auditor to apply due professional care and exercise professional skepticism in planning and performing his or her work, including responding to the risks of material misstatements. Due to the special risks posed by fraud, the Board believes that providing additional direction regarding how to respond to fraud risks can be helpful.

IAASB and ASB

The ISAs and the proposed SASs require the auditor to plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materiality misstated.

4. Evaluating Effectiveness of Controls in the Audit of Financial Statements

PCAOB

In discussing obtaining evidence about the effectiveness of controls in the audit of financial statements, the proposed standard establishes the principle that the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The greater the reliance on a control, the more persuasive evidence the auditor is required to obtain from the tests of controls. In addition, the auditor is required to obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls. This requirement is an extension of the principle in the existing standard.

IAASB and ASB

The ISAs and the proposed SASs include a similar requirement for the auditor to obtain more persuasive audit evidence the greater the reliance he or she plans to place on the effectiveness of a control.

5. Testing Operating Effectiveness of a Control

PCAOB

In discussing testing of operating effectiveness, the proposed standard requires the auditor to determine whether the control selected for testing is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. The proposed standard also discusses the procedures the auditor performs in testing operating effectiveness. To help facilitate the test of controls in an integrated audit, the proposed standard continues to use language similar to that of Auditing Standard No. 5 when describing analogous terms and concepts relating to the testing of controls.

IAASB and ASB

The ISAs and the proposed SASs do not have a similar requirement to determine whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

6. Tests of Controls in Integrated Audits

PCAOB

The proposed standard contains a requirement to design the tests of controls to meet the objectives of both the audit of the financial statements and the audit of internal control over financial reporting in an integrated audit. This requirement is adapted from existing PCAOB standards.[17/] Integrated audits are unique to PCAOB standards.

IAASB and ASB

The ISAs and proposed SASs do not include similar requirements.

[17/] Paragraph 7 of Auditing Standard No. 5.

RELEASE

7. Rotational Testing of Controls

PCAOB

The proposed standard contains a requirement to obtain evidence in the current year about the design and operating effectiveness of controls selected for testing. Appendix 9 discusses this subject in further detail.

IAASB and ASB

The ISAs and proposed SASs allow rotational testing of controls under certain conditions set forth in the standards, and those standards contain requirements that apply to the use of evidence about controls obtained in prior audits.

8. Assessing Control Risk

PCAOB

The proposed standard contains a requirement to assess control risk for relevant assertions by evaluating the evidence from all sources, including the auditor's testing of controls for the audit of internal control and the audit of the financial statements, misstatements detected during the financial statement audit, and any identified control deficiencies. The proposed standard also would require that control risk be assessed at the maximum level for relevant assertions for which controls necessary to sufficiently address the assessed risk of material misstatement in those assertions are missing or ineffective or when the auditor has not obtained sufficient appropriate audit evidence about the effectiveness of those controls. These requirements are adapted from existing PCAOB standards.[18/]

IAASB and ASB

The ISAs and proposed SASs contain requirements regarding evaluating the operating effectiveness of controls and identified control deviations, but those standards do not require a separate assessment of control risk.

18/ AU sec. 319.86 and paragraphs B4-B5 of Auditing Standard No. 5.

RELEASE

9. Dual-purpose Tests

PCAOB

The proposed standard states that, when dual-purpose tests are performed, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested. These requirements are adapted from existing PCAOB standards.[19/]

IAASB and ASB

The ISAs and proposed SASs do not have similar requirements.

10. Substantive Procedures

PCAOB

The proposed standard has a requirement, adapted from existing PCAOB standards, to perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.[20/] Like existing standards, the proposed standard focuses the auditor's responses on relevant assertions of significant accounts and disclosures.

IAASB and ASB

The ISAs state, "The auditor shall design and perform further audit procedures whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level." The proposed SAS includes similar requirement except that it uses the term "relevant assertion."

19/ AU sec. 319.108.

20/ AU sec. 319.02.

RELEASE

11. Consideration of Confirmations

PCAOB

As discussed above, the proposed standard requires the auditor to perform substantive procedures for each relevant assertion of each significant account and disclosure. The standard also discusses how to determine the types and combination of substantive audit procedures necessary to detect material misstatements in relevant assertions.

AU sec. 330, *The Confirmation Process*, establishes requirements regarding the use of confirmation procedures.[21/] The proposed risk assessment standards discuss the auditor's responsibilities for designing and performing the substantive procedures necessary to address the risks of material misstatement.

IAASB and ASB

ISA 330 specifically requires the auditor to consider whether external confirmation procedures are to be performed as substantive audit procedures. The proposed SASs does not contain such a specific requirement.

12. Determining Whether to Perform Interim Substantive Procedures

PCAOB

The proposed standard requires the auditor to take into account a series of factors when determining whether it is appropriate to perform substantive procedures at an interim date. The factors discussed in the proposed standard are adapted from existing requirements in PCAOB standards.[22/]

IAASB and ASB

The ISAs and the proposed SASs do not contain an equivalent requirement for the auditor to take into account the factors listed in the PCAOB proposed standard

21/ The Board has a separate standard setting project on confirmations.

22/ Paragraphs .04-.07 of AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date*.

when determining whether it is appropriate to perform substantive procedures at an interim date.

13. Substantive Procedures Covering the Remaining Period

PCAOB

In describing the auditor's responsibilities regarding performing substantive procedures covering the remaining period when certain substantive procedures have been performed at an interim date, the proposed standard has a requirement to compare relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual. This requirement is adapted from existing PCAOB standards.[23/]

IAASB and ASB

The ISAs and proposed SASs contain requirements to cover the period between the interim testing date and year end by performing substantive procedures, combined with tests of controls for the intervening period, or by performing further substantive procedures only if the auditor determines that doing so would be sufficient.

14. Response to Significant Risks

PCAOB

The proposed standard adapted a requirement from existing PCAOB standards to perform substantive procedures, including tests of details, that are specifically responsive to significant risks.[24/]

The Board believes that requiring the auditor to perform tests of details that are specifically responsive to significant risks is appropriate as (1) the nature and importance of significant risks warrant a high level of assurance from substantive procedures to adequately address the risk; and (2) analytical procedures alone are not well suited to detecting certain types of misstatements related to significant risks,

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23/ AU sec. 313.08.

24/ Paragraph .09 of AU sec. 329, *Analytical Procedures*.

including, in particular, fraud risks. See Appendix 9 for further discussion regarding this topic.

IAASB and ASB

The ISAs state –

> If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

The proposed SASs include similar requirements.

Proposed Auditing Standard – Evaluating Audit Results

In this section, the analogous IAASB standards are ISA 450, *Evaluation of Misstatements Identified During the Audit,* ISA 330, *Auditor's Responses to Assessed Risks,* ISA 520, *Analytical Procedures,* ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements,* ISA 540, *Auditing Accounting Estimates Including Fair Value Accounting Estimates, and Related Disclosures,* and ISA 700, *Forming an Opinion and Reporting on Financial Statements* (collectively referred as "the ISAs"). The analogous ASB standards are proposed SASs, *Evaluation of Misstatements Identified During the Audit, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained, Understanding the Entity and its Environment and Assessing the Risks of Material Misstatements, Consideration of Fraud in a Financial Statement Audit,* Proposed Statement on Auditing Standards, *Analytical Procedures,* and *Forming an Opinion and Reporting on Financial Statements* (collectively referred to as "the proposed SASs").

1. Performing Analytical Procedures in the Overall Review

PCAOB

In the overall review, the proposed standard contains requirements to read the financial statements and disclosures and perform analytical procedures to (a) assess the auditor's conclusions formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement. These requirements were adapted from existing PCAOB standards.[25] The conclusions formed from the results of the overall review of the audit are intended to corroborate the conclusions formed during the audit of the significant accounts and disclosures and the financial statements as a whole.

IAASB and *ASB*

The ISAs state –

> The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

The proposed SASs have similar requirements.

2. Evaluating Evidence from Analytical Procedures

PCAOB

The proposed standard contains a requirement, which was adapted from existing PCAOB standards,[26] to evaluate whether the evidence gathered in response to unusual or unexpected transactions, events, amounts or relationships previously identified during the audit is sufficient, and whether unusual or unexpected transactions, events, amounts, or relationships indicate risks of material misstatement that were not identified previously, including, in particular fraud risks as part of the overall review. The proposed standard specifies the matters that the auditor should evaluate during the overall review.

IAASB

The ISAs state –

> The auditor shall evaluate whether analytical procedures that are performed near the end of the audit, when forming an overall conclusion as to whether the financial statements as a whole are consistent with the

[25] AU sec. 329.23.

[26] Ibid.

RELEASE

auditor's understanding of the entity and its environment, indicate a previously unrecognized risk of material misstatement due to fraud.

ASB

The proposed SASs state –

The auditor should evaluate whether the accumulated results of auditing procedures, including analytical procedures, that are performed during the audit, in the overall review stage, or in both stages, when forming an overall conclusion concerning whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment, indicate a previously unrecognized risk of material misstatement due to fraud.

3. Analytical Procedures Regarding Revenue

PCAOB

The proposed standard includes a requirement, adapted from existing standards for the auditor to perform analytical procedures relating to revenue through the end of the period.[27/] These procedures are intended to identify unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement due to fraudulent financial reporting.

IAASB

The ISAs state –

The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

27/ AU sec. 316.70.

RELEASE

ASB

The proposed SASs include a similar requirement as the proposed PCAOB standard to perform analytical procedures related to revenue.

4. Corroborating Management Explanations

PCAOB

The proposed standard contains a requirement to corroborate management's explanations regarding significant unusual or unexpected transactions, events, amounts or relationships. The proposed standard also states that if management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures as necessary to address the matter. The proposed standard specifically requires the auditor to corroborate management's explanations regarding significant matters.

IAASB and ASB

The ISAs require the auditor to investigate the identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount by (a) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and (b) performing other audit procedures as necessary in the circumstances. The ISAs also include a requirement to investigate inconsistent responses to inquiries from management and those charged with governance.

The proposed SASs have similar requirements.

5. Accumulating and Evaluating Identified Misstatements

PCAOB

The proposed standard contains a requirement to communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them as further discussed in Appendix 9. This requirement fulfills the auditor's responsibility to communicate the misstatements and a subsequent provision of the standard discusses the auditor's responsibility for evaluating the misstatements that are corrected.

IAASB and *ASB*

The ISAs and proposed SASs contain requirements to communicate on a timely basis all misstatements accumulated during the audit to an appropriate level of management and to request that management correct those misstatements.

6. Evaluating Misstatements – Effect on Risk Assessments

PCAOB

The proposed standard contains a requirement to evaluate the effect of individual misstatements accumulated during the audit on the assessed risks of material misstatements in determining whether the risk assessments remain appropriate. Such an evaluation is important to inform the auditor's conclusions about whether the auditor's risk assessments remain appropriate and whether he or she has obtained sufficient appropriate evidence to support his or her opinion.

IAASB and *ASB*

The ISAs and proposed SASs do not have a similar requirement to evaluate the effect of individual misstatements accumulated during the audit on the assessed risks of material misstatement.

7. Evaluating Misstatements – Fraud Considerations

PCAOB

The proposed standard has a requirement, adapted from existing PCAOB standards, to evaluate whether identified misstatements might be indicative of fraud and, in turn, how they affect the auditor's evaluation of materiality and the related audit responses.[28/] Like existing standards, this requirement is phrased in terms of identified misstatements rather than accumulated misstatements because fraud of relatively small amounts can be material to the financial statements. If an auditor detects a misstatement, he or she should evaluate whether the misstatement is indicative of fraud

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[28/] AU sec. 316.75.

when deciding whether a misstatement is clearly trivial and thus does not warrant including with accumulated misstatements.

IAASB and *ASB*

The ISAs and proposed SASs contain a requirement to evaluate whether a misstatement is indicative of fraud, and if so, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations. The proposed SASs contain a similar requirement to the ISAs and also require the auditor to evaluate the implications of the misstatement on the auditor's evaluation of materiality, management, and employee integrity.

8. Communication of Illegal Acts

PCAOB

The proposed standard requires the auditor to determine his or her responsibility under AU sec. 316.79-.82A, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j-1, if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred.

IAASB and ASB

The ISAs state that if the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management. The proposed SASs have a similar requirement.

9. Evaluating the Qualitative Aspects of the Company's Accounting Practices

PCAOB

The proposed standard states that if the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, he or she should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. The proposed standard also contains a requirement to evaluate whether the auditor's risk assessments, including assessment of risks of material misstatement due to fraud and the related responses remain appropriate.

The purpose of this provision is to direct the auditor to evaluate potential bias in the financial statements, and if such bias exists, whether the effect of management bias in combination with the accumulated uncorrected misstatements causes the financial statements to be materially misstated, and thus not presented fairly in accordance with the applicable financial reporting framework. See further discussion in Appendix 9.

IAASB and ASB

The ISAs and proposed SASs contain a requirement for the auditor to evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

10. Evaluating Conditions Relating to Assessment of Fraud Risks

PCAOB

The proposed standard contains a requirement, which was adapted from existing PCAOB standards, for the engagement partner to ascertain whether there has been appropriate communication with the other engagement team members regarding information or conditions indicating fraud risks.[29/] This requirement imposes a specific responsibility for the engagement partner to determine that necessary fraud related matters have been communicated.

IAASB

The ISAs contain a requirement for a discussion among the engagement team members and a determination by the engagement partner of matters to be communicated to those team members not involved in the discussion.

[29/] AU sec. 316.18.

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ASB

The proposed SASs contain a similar requirement to the PCAOB proposed standard for the engagement partner to ascertain that appropriate communication exists about the need for the discussion of fraud risks among team members throughout the audit.

Proposed Auditing Standard – Audit Evidence

In this section, the analogous IAASB and ASB standards are ISA 500, *Audit Evidence,* and proposed SAS, *Audit Evidence (Redrafted)*, respectively.

1. Objective and Overarching Requirement

PCAOB

The objective of the auditor in the proposed standard is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report. The proposed standard includes a requirement, adapted from existing PCAOB standards, for the auditor to design and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for the auditor's opinion.[30/] The objective of the proposed standard together with the requirement clearly articulates the linkage between the auditor's responsibility to obtain sufficient appropriate audit evidence and to support his or her opinion.

IAASB and ASB

The objective of the auditor in the ISA states, "The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion." The requirement of the ISA states, "The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence." The proposed SAS has a similar objective and requirement.

[30/] Paragraph .22 of AU sec. 326, *Evidential Matter*.

2. Document Authentication

PCAOB

The proposed standard includes a statement, adapted from existing PCAOB standards, that the auditor is not expected to be an expert in document authentication. The proposed standard also states that if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should determine the effect, if any, on the other aspects of the audit.[31/]

IAASB and ASB

The ISA states, "Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further." The proposed SAS includes a similar requirement.

3. Evaluating Information Produced by the Company

PCAOB

The proposed standard includes a requirement, adapted from existing PCAOB standards, to evaluate whether the information produced by the company is sufficient and appropriate for the purposes of the audit, by performing procedures such as –

- Testing the accuracy and completeness of the information, or testing the controls over the accuracy and completeness of that information.

- Evaluating whether the information is sufficiently precise and detailed for purposes of the audit.

[31/] AU sec. 316.09 and AU sec. 316.68, footnote 26.

IAASB and ASB

The ISA and the proposed SAS include requirements to evaluate whether the information produced by the entity is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances –

- Obtaining audit evidence about the accuracy and completeness of the information.
- Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.

4. Selecting Items for Testing to Obtain Audit Evidence

PCAOB

The proposed standard states that the auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. This establishes an overall principle for selecting items for testing, consistent with an existing auditing interpretation.[32/]

IAASB and ASB

The ISA indicates that when designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. The proposed SAS has a similar requirement.

[32/] AU sec. 9350, *Audit Sampling: Auditing Interpretations of Section 350.*

PCAOB
Public Company Accounting Oversight Board

Exhibit 2(a)(E)

Alphabetical List of Comments
American Accounting Association, Auditing Standards Committee
BDO Seidman, LLP
CalPERS, Anne Simpson, Senior Portfolio Manager, Global Equity
Center for Audit Quality, Cynthia M. Fornelli, Executive Director
Crowe Horwath LLP
Deloitte & Touche LLP
Ernst & Young LLP
Federation of European Accountants, Hans van Damme, President
Grant Thornton LLP
Institut der Wirtschaftsprüfer in Deutschland e.V., Klaus-Peter Feld, Executive Director
Professor William Kinney, The University of Texas at Austin
KPMG LLP
Mazars, Denis Usher, Mazars US Desk; Jean-Luc Barlet, Mazars Chief Compliance Officer
McGladrey & Pullen LLP
Patrick Montgomery
Moss Adams LLP
New York State Society of Certified Public Accountants, David J. Moynihan, President

PricewaterhouseCoopers LLP
Texas Society of Certified Public Accountants, Melissa A. Frazier, Chair, Professional Standards Committee
The Institute of Chartered Accountants in England and Wales, Katharine E Bagshaw, Manager, Auditing Standards
The Institute of Internal Auditors, Richard F. Chambers, President and Chief Executive Officer
U.S. Chamber of Commerce Center for Capital Markets Competitiveness, Tom Quaadman
U.S. Government Accountability Office, Jeanette M. Franzel, Managing Director, Financial Management & Assurance

February 25, 2010

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Via email to comments@pcaobus.org

RE: PCAOB Rulemaking Docket Matter No. 026: Re-Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk; Proposed Conforming Amendments to PCAOB Standards.

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on the *PCAOB Rulemaking Docket Matter No. 026: Re-Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk; Proposed Conforming Amendments to PCAOB Standards*. We very much appreciate the opportunity to provide input.

The views expressed in this letter and attachments are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist in finalizing the proposed guidance. If the Board has any questions about our input, please feel free to contact our committee chair for additional follow-up.

Respectfully submitted,

Auditing Standards Committee
Auditing Section - American Accounting Association

Committee Members:
Chair, James Bierstaker, Villanova University
Joseph Brazel, North Carolina State University
Steven Glover, Brigham Young University
Ed O'Donnell, Southern Illinois University
Randal J. Elder, Syracuse University
Robert J. Ramsay, University of Kentucky
Sandra Shelton, DePaul University

General Comments

The Committee encourages the PCAOB ("the Board") to maintain consistency with International Standards on Auditing (ISA's) when developing new standards. We suggest the PCOAB use existing standards (AU's and ISA's) as the baseline and then make adjustments as necessary for public company audits. This would allow the PCAOB to leverage the work of the ISA and ASB and reduce the unnecessary differences between the standards (Glover et al. 2009). For example, the clarified Auditing Standards Board standards (AU's) start with ISA's and then make changes for the United States based on the expertise of ASB members, which enhances convergence between the AU and ISA. Similarly, the PCAOB could use AU's as their base of standards. We believe that it would be preferable to have one set of primary standards (based on ISA's and AU's), with PCAOB auditing standards for requirements unique to U.S. registered securities when necessary. With these standards, the Board is moving toward the development of comprehensive standards that are largely overlapping with other auditing standards.

The following section presents a number of specific comments or suggestions relating to the proposed standards, organized along the lines of the questions posed by the Board in Appendix 9 of the proposed standards.

Comments Addressing PCAOB-proposed Questions

Proposed Auditing Standard, *Audit Risk*

2. Does the new proposed standard on audit risk describe clearly the concept of audit risk and its components?

The revised standards consistently use the label "risk" when referring both to auditor judgment about the likelihood for material misstatement and the actual likelihood of material misstatement. Those two constructs are very different. Using the terms interchangeably in an auditing standard could cause expectations gaps. The generally accepted interpretation of the term "risk" is probability or likelihood. Because auditors never know the actual likelihood, they never really respond to risk as the public understands risk. An auditor's assessment of and response to risk actually refers to their informed opinion (or assessment) about the likelihood for material misstatement and the decisions (or response) motivated by that opinion. Auditors respond to evidence under ambiguous conditions, that is, conditions characterized by second order uncertainty. They are never in a position to respond to risk by evaluating evidence when they know the actual probability that misstatement exists. Perhaps the Board should consider defining these terms separately.

Paragraph 8 states "Inherent risk and control risk are the company's risk; they exist independently of the audit". This wording can cause confusion regarding the importance of inherent risk and control risk on the auditor's actions. It would be better to emphasize that inherent risk and control risk are a function of the company's characteristics but influence the auditor's actions. It would be helpful to emphasize that the auditor assesses these risks using risk assessment procedures and then design testing to be responsive to those risks. In addition, while the assumption that inherent risk is independent of the audit has been commonly held over time, the statement that control risk is independent of the audit implies that the cost-benefit decision (audit/test controls more (cost) to reduce control risk more (benefit) that is present in private company audits is not an option for public company audits (i.e., in private company audits control risk is typically not independent of the audit). The standards suggest that, for public companies, the auditor is required to test controls (for all material cycles) until control risk can be set at a minimum or "low" level or a significant deficiency or material weakness should be reported. While this statement is appropriate for large public company audits, the standards should highlight this difference from the audits of small public or privately held entities.

Throughout the standards the phrase "misstatement…that could be material, individually or *in combination with other misstatements*" is used. Clearly, any misstatement could be material "in combination with other misstatements." This phrase apparently refers to the idea of tolerable misstatement. The standards should clarify the link to tolerable misstatements. Also, the standards provide guidance as to how tolerable misstatement is determined, but they should explain how auditors incorporate the concept in risk assessment. For example, is the amount different for different accounts, assertions, or disclosures?

There is surprisingly little discussion of going concern risk. The standards rightly mention the entity's going concern as an important disclosure and refer to AU 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern". However, AU 341 does not direct auditors to specifically accumulate information about the entity's going concern status in the planning stage. Many of the procedures required in these standards would provide important information about whether the entity can continue as a going concern. The standards should specifically include gathering information about the entity's ability to continue as a going concern as part of the risk assessment procedures.

The report of the risk assessment team of the PCAOB research synthesis program recommends using risk assessment measures from other fields such as systems dynamics, data envelopment analysis, and others to evaluate potential risks (Allen et al. 2006). Consider recommending or mentioning such procedures for auditors. The research synthesis team also points out that fraud risk assessments are enhanced by considering fraud risks separately from risk of misstatements due to error. This might be specifically suggested in the standards. Round numbers ($10,000) or numbers slightly below a threshold ($9,999) are other important indicators of fraud that could be included in Appendix C of "Evaluating Audit Results".

Proposed Audit Standard, *Consideration of Materiality in Planning and Performing an Audit*

7. Are the provisions in the new proposed standard regarding consideration of materiality in multi-location engagements appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?

We agree that materiality at an individual location or component cannot exceed, and generally should be less than, materiality for the financial statements as a whole. We suggest the Board consider providing additional guidance in the area of multi-location or group engagements. PCAOB inspections have noted a wide variety of practices in the area of materiality in multi-location or group audits. Some of the practices have been troubling. For example, some group engagement teams have allocated the full materiality for the financial statements taken as a whole to all components, even when there are a large number of components. Such an allocation methodology can result in an unacceptable level of audit risk at the group level (see Glover et al., 2009). To partially address this troublesome practice, the proposed standard could include simple directional guidance such as, “as the number of locations or business units increases, the size of unit materiality generally decreases in proportion to materiality for the financial statements taken as a whole.” For other examples of additional guidance see ISA 600.21-23, A42-A46, and Glover et al. 2009. For example, ISA 600.21 clarifies that the unit or component materiality is established by the *group engagement team*. This is important to adequately address audit risk at the group level. ISA 600.23 discusses statutory audits at the component level (e.g., component materiality for a publicly traded subsidiary). ISA 600.43 clarifies that different component materiality may be established for different components and that component materiality need not be an arithmetical portion of financial statement materiality. Importantly, A43 clarifies that the aggregate of component materiality may exceed the materiality for the group financial statements as a whole. This notion that the aggregation of component materiality can be greater than financial statement materiality is similar in concept to the concern raised below regarding tolerable misstatement in the proposed standard.

In the section on tolerable misstatement we believe there is the potential for confusion. The proposed standard, “Consideration of Materiality in Planning and Performing an Audit” uses both terms “amount” and “amounts” of tolerable misstatement. Does “amounts” relate to classes of transactions (see note 2 in Appendix 3) or is it the plural form of amount and thus is the aggregate of all the tolerable misstatements? If it is the plural, a reader could inappropriately interpret “amounts of tolerable misstatement should be less than materiality level” as a requirement that the summation or aggregation of the individual tolerable misstatements cannot exceed materiality for the financial statements taken as a whole (a similar inappropriate interpretation could be made from PCAOB Interim Standard AU350.18 “combined for the entire audit.”) We do not believe the use of the term “amounts” is useful or necessary in the proposed standard. Furthermore, it is not conceptually correct, or consistent with current practice in the U.S. or internationally, to cap the summation or aggregation of the individual tolerable misstatements to financial statement materiality. For further discussion on the determination and allocation of tolerable misstatement see Zuber, et al.

(1983) and the AICPA 2008 Audit Sampling Guide. Capping the aggregation of tolerable misstatements to financial statement materiality would result in over-auditing.

8. Are the revised provisions regarding reassessment of materiality appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?

Similar to having different materiality for particular accounts and disclosures, the standards should discuss the propriety of having different quantitative materiality levels for different evaluations. For example, a larger materiality amount is likely used to evaluate misstatements that have no effect on net income (see AICPA 2008 Audit Sampling Guide). Auditors also likely use a larger materiality amount for applying a misstatement to prior periods under SAB 108. The propriety of using different materiality measures in these instances should be addressed. The standards should also clarify how having lower materiality for particular accounts and disclosures (e.g., related party transactions) is different than tolerable misstatement.

Proposed Audit Standard, *Identifying and Assessing the Risks of Material Misstatement*

9. Does the new proposed standard adequately describe the auditor's responsibilities for performing risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of risks of material misstatement due to error or fraud and to design further audit procedures?

The proposed standard makes clear the auditor’s responsibilities for performing risk assessment procedures. The wording of paragraph 5 is helpful in that it notes that risk assessment procedures require gathering evidence. This wording helps auditors understand the importance of the risk assessment procedures and that they should be considered as important as tests of controls and substantive tests.

However, there are two reasons that assessments of fraud risks and business risks may fail to affect the scope of testing. First, the standards are silent as to whether these assessments should be at the engagement, cycle, account, or assertion level. Perhaps the most efficient method would be one assessment for each at the engagement level. Second, the standards provide little to no guidance on how fraud risk and business risk are to be incorporated into the audit risk model. Specific guidance on how business risks should be incorporated in the assessment of inherent risk would be useful. Although the standards address how auditors should respond to the risk of fraud, they do not address whether identified fraud risk should affect assessments of inherent risk.

In addition, the discussion of industry, regulatory and other external factors in paragraph 9 should be expanded to provide similar detail as the other categories of risk factors. For example, it should include a discussion of tax policies, international customs and regulations, etc. Moreover, the discussion of performance measures in paragraph 17 should be expanded to include incentives the performance measures may provide for management to misstate the financial statements. The discussion on page A9, paragraph 31 might be helpful in this regard.

Paragraph 49 – In the third bullet point, consider adding of "of internal controls" to "management override." In the discussion of potential responses (fourth bullet point), research has shown time and time again that auditors have difficulty changing the nature of tests in relation to variation in fraud risk (Zimbelman 1997; Glover et al. 2003; Asare and Wright. 2004). This may be an expertise issue and most audits (especially medium to high fraud risk audits) would benefit greatly from a fraud specialist assisting in this area. Thus, the fourth bullet point should stress that consideration should be given to using a fraud specialist. The fraud brainstorming requirement and potential need to include a forensic specialist should be cross-referenced in the standard *Audit Planning and Supervision*.

The requirement to understand communications on page A4-13 in paragraph 32 should include understanding how management communicates to employees involved in the financial reporting process. Paragraph 53.c(3) on page A4-21 should include inquiring about the results of internal auditors' procedures, and paragraph B4 on page A4-32 should refer to AU 324 "Service Organizations."

Finally, there should be some discussion of planning procedures to audit beginning balances where a previous audit has not occurred.

10. Are the auditor's responsibilities regarding the additional procedures for understanding the company and its environment in paragraph 11 clear?

The requirement to understand communications on page A4-13 in paragraph 32 should include understanding how management communicates to employees involved in the financial reporting process, paragraph 53-c-3 on page A4-21should include inquiring about the results of internal auditors' risk assessments, control documentation, and audit procedures, and on page A4-32, paragraph B4 should refer to AU 324 "Service Organizations".

11. Are the proposed requirements regarding obtaining an understanding of internal control over financial reporting appropriate in light of the auditor's responsibilities for identifying and assessing the risks of material misstatement?

Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*

Paragraphs 19 and 20 discuss how auditors should test the design effectiveness of internal controls. The Board should consider replacing "test" with "evaluate." Auditors pass judgment on the design effectiveness of internal control by learning what controls are in place then evaluating whether those procedures accomplish all of the control objectives that should be in place. Auditors test control effectiveness by gathering evidence that the control is working like it was intended to work. Auditing standards use "test" when referring to a procedure for gathering evidence that something was done correctly. Evaluating design effectiveness simply involves learning how controls are supposed to work then forming an opinion about whether the suite of controls provides sufficient protection. Auditors don't need any evidence about whether the process was executed correctly. Using the term "test" with respect to forming an opinion about both design and operational effectiveness suggests that these two activities are similar in ways that they are not.

In addition, the discussion of industry, regulatory and other external factors in paragraph 9 should be expanded to provide similar detail as the other categories of risk factors. For example, it should include a discussion of tax policies, international customs and regulations, etc. Moreover, the discussion of performance measures in paragraph 17 should be expanded to include incentives the performance measures may provide for management to misstate the financial statements. The discussion on page A9, paragraph 31 might be helpful in this regard.

Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*

13. Are the proposed requirements for overall responses and responses involving the nature, timing, and extent of audit procedures appropriate given the auditor's responsibility to opine with reasonable assurance about whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?

Paragraph 36 says: "The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure…" The standard should indicate if a significant account is the same as a material account. If so, use the label "material." If not, the standard should define what a "significant" account is. The standard should reference the definition of significant accounting in AS5 as in footnote 26 on Page A4-23.

14. Does the new standard clearly describe when tests of controls are necessary in an audit of financial statements only?

The standard is fairly clear that tests of controls need only be performed in an audit of financial statements only if the auditor plans to assess control risk less than the maximum (paragraph 16), or if substantive procedures alone do not provide sufficient appropriate evidence (paragraph 17). However, there has been some confusion by practitioners and in academia as to whether choosing not to test controls is an appropriate audit strategy when a substantive approach is deemed more efficient. Further, paragraph 16 appears to require annual testing of controls and eliminate rotational testing, even for automated controls. Any guidance in AS5 would not be considered applicable to an audit of the financial statements only. Additional guidance in the standard on this issue would be helpful.

The standard would also seem to indicate that no reduction on control risk should occur based on understanding the design effectiveness of controls. However, a control that does not exist or is designed ineffectively should have a different impact on testing than a control that is designed effectively, but was not tested by the auditor. However, according to the standard, each situation would result in control risk assessed at the maximum.

Paragraph 34(a) should indicate if the Board is referring to compensating controls. It is unclear what controls are being discussed. Auditors test key controls for each assertion on which they may be able to assess control risk as less than maximum. If those controls are not functioning to the auditor's satisfaction, what other controls could be tested to support a control risk assessment at less than maximum?

Additional Comments on the PCAOB-proposed Auditing Standards

Proposed Audit Standard, *Audit Planning and Supervision*

In Paragraph 7, there should be a specific emphasis on preliminary analytical procedures as an integral part of planning, separate from analytical procedures performed as risk assessment procedures. The importance of auditors' fraud risk assessments, including brainstorming, should also be emphasized as an important part of audit planning. "Matters affecting the industry" should include knowledge of important accounting principles. Paragraph 9 should discuss the need for specialists.

Paragraph 15 – In cases where changes are made during the course of the audit, it would be prudent to mention that the audit fee or budgeted hours of the engagement should be re-assessed to determine if they are adequate, given the change. Otherwise it is possible that the re-assessment will not be done due to budgetary constraints, or that re-assessments will lead to under-auditing if the fee or audit budget are not re-addressed.

Paragraph 23 (c) – Given the percentage of time engagement management spends in review (because of its importance), it is surprising to observe that only a few paragraphs were devoted to review. Specifically, it might be necessary to provide examples of "levels of supervision" in relation to review. For example, research shows that face-to-face review methods are preferred by reviewers when risks are high as this review method positively affects the effectiveness of preparers' work (Brazel et al 2004; Payne et al. 2010; Agoglia et al 2010). However, reviewers find electronic review more efficient and choose to use this method when balancing multiple clients. We have learned much about the review process through research since SAS 22. It might be prudent to incorporate this knowledge efficiently into this standard.

Proposed Audit Standard, *Sufficient Appropriate Audit Evidence*

On page A7-2, paragraph 7, the definition of quality of evidence as relevant and reliable, although consistent with current standards, is necessary, but not sufficient. For example, testing calculations for a complex derivative is both relevant and reliable for the valuation assertion. However, it is not sufficiently persuasive. Another factor is needed in the definition of appropriate evidence. Consider adding language regarding the "diagnosticity" or "persuasiveness" of the evidence.

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Tel: 212-885-8000
Fax: 212-697-1299
www.bdo.com

100 Park Avenue
New York, NY 10017

March 2, 2010

Via E-mail: comments@pcaobus.org

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Release No. 2009-007, Rule Making Docket Matter No. 026,
Proposed *Auditing Standards Related to the Auditor's Assessment of and Response to Risk,* **and** *Related Amendments to PCAOB Standards*

Dear Members and Staff of the Public Company Accounting Oversight Board:

BDO Seidman, LLP welcomes this opportunity to comment on the PCAOB's *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Related Amendments to PCAOB Standards* (the "new proposed standards"). Overall, we believe that the new proposed standards have enhanced the clarity of the original proposed risk assessment standards, such that they more clearly set out the Board's expectations with respect to planning and performing an audit using risk assessment principles. Additionally, we appreciate the efforts made by the Board to promote transparency into the standards-setting process by re-exposing these standards and providing enhanced discussion within the release regarding the Board's rationale for the more significant decisions made.

As set out in our comment letter on the original proposed standards, we support the Board's objective to update its extant interim standards to more fully incorporate guidance about the risk assessment process, including gathering information, evaluating that information to assess risks at the assertion level, designing and performing further audit procedures, and evaluating results and reaching an appropriate conclusion. We believe the new proposed standards largely achieve that goal.

Our comments are organized such that our overall comments are provided first, followed by our responses to the specific questions posed in the release, which include additional commentary on certain matters specific to an individual Appendix.

Overall Comments

Structure and Organization of the New Proposed Standards
To assist practitioners in understanding and effectively implementing the PCAOB's standards, we encourage the Board to continue to apply a consistent structure in developing its standards, including (1) the use of objectives that provide the context within which the requirements of the standard are to be performed, and (2) the use of appendices that

include definitions of technical terms and expand upon special topics. A consistent framework in developing standards promotes a clear understanding of the requirements within a standard and the methods to implement those requirements.

Two areas where we believe the structure of the proposed standards may be improved include the use of notes and appendices within the standards. We understand that notes and appendices are integral parts of the standards and as such, they carry the same authoritative weight as other portions of the standards; however, we believe that setting requirements in notes and appendices may obscure essential guidance. We believe the structure of the standards would be enhanced by organizing the standards such that notes only provide further clarification and do not introduce additional requirements. Further, we believe that the guidance included within appendices should not include requirements not otherwise mentioned in the body of the standard, but rather should provide supplementary or explanatory material on a special topic. This would be similar to the manner in which appendices are used in the International Auditing and Assurance Standards Board (IAASB) and Auditing Standards Board (ASB) standards, where appendices are also considered an integral part of the standards.

Convergence
We understand that the PCAOB, in developing these new proposed standards, has taken into account the risk assessment standards of the IAASB, and we support this convergence effort. In describing the rationale for the differences that exist between the IAASB standards and the new proposed standards, Appendix 9 to the release explains that since the Board's standards must be appropriate for audits of issuers and consistent with the Boards' statutory mandate to oversee the audit of public companies that are subject to the securities laws, its standards will necessarily differ in some respects from IAASB standards. While we agree that certain differences will necessarily exist to reflect the PCAOB's mandate to oversee audits of public companies, these differences are not always specific to auditing in a public company environment.

For example, the International Standards on Auditing (ISAs) use the term "performance materiality" when referring to the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. The PCAOB standards use the term "tolerable misstatement" for the same concept. We strongly recommend that the PCAOB eliminate these types of differences, such that the remaining differences between the standards reflect only differences necessary as a result of aspects unique to the U.S. public company environment and/or for which auditor performance is expected to differ. This is particularly important for those firms that audit both public and private companies and those that audit companies with operations in multiple countries, which as a matter of practicality, therefore, use the ISAs as the basis for their uniform methodologies for the worldwide network.

Additionally, we suggest listing differences from the ISAs that are expected to result in significant differences in practice, such that if a difference were not listed, it could be presumed not to be a significant difference that would require a different auditor response than under the ISA.

Collaboration with Other Audit Standards-Setters
We acknowledge the steps the PCAOB has taken to participate with other standards-setters in the development of auditing standards, for example, through attending IAASB meetings, inviting the IAASB and ASB Chairmen to join the SAG meetings, and participating in joint meetings of standards-setters. We support these efforts and encourage the PCAOB to work more collaboratively with the IAASB and ASB, through participation on IAASB and ASB task forces to benefit from the discussions held at this level in formulating the public company perspective.

Additionally, we believe the Board could enhance its standards-setting process by establishing external task forces to participate in developing and updating its own auditing standards. Such an approach was used previously by the PCAOB in developing the PCAOB's *Staff Views of An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies.* This guidance was developed, under the oversight of the PCAOB, by a working group of auditors with experience in this subject matter. In developing this guidance, the PCAOB also consulted with financial executives from smaller public companies.

Transparency of Standards-Setting Process
We encourage the PCAOB to continue to engage the various stakeholders in the standards-setting process through the use of concept releases, re-exposing proposed standards when necessary, and discussions at the open Standing Advisory Group meetings. Also, as mentioned above, an important aspect of transparency is providing a complete and clear analysis of differences between the PCAOB's standards and the ISAs and, in particular, where such differences are expected to result in a different auditor action, we urge the PCAOB to provide such an analysis.

Effective Date
We note that the effective date set out in the release is expected to be for audits of fiscal years beginning on or after December 15, 2010. In setting an effective date, we encourage the Board to consider the time required for SEC approval, in addition to the time required by firms to incorporate the standards into their audit methodologies and provide for training prior to implementation. As such, we suggest revising the anticipated effective date if these new proposed standards are not approved by the SEC prior to June 2010.

Specific Questions Posed in the Release

1. **Are the objectives in the new proposed standards useful in providing context for the requirements in the standards?**

Yes. We support the use of objectives in the new proposed standards and believe objectives should be established for all PCAOB Auditing Standards. The use of objectives in each auditing standard establishes a useful context for the auditor to evaluate whether the procedures performed were sufficient to meet the stated objective. Such a construct strengthens the standard and, as a result, audit quality is enhanced.

Appendix 1 - Audit Risk

2. **Does the new proposed standard on audit risk describe clearly the concept of audit risk and its components?**

While the discussion in the new proposed standard appropriately defines audit risk as a function of the risks of material misstatement and detection risk, it does not include a discussion that explains that the assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit, and that the assessment of such risks is a matter of professional judgment. Accordingly, we recommend including such a discussion.

Further, we suggest clarifying that in assessing risk the auditor must evaluate both control risks and inherent risks, but that a separate conclusion (e.g. high, medium, low) is not necessary for each of these separately in reaching the conclusion as to the risk of material misstatement for any assertion. We believe that the current discussion of risk may inappropriately imply that a conclusion for each aspect of risk is necessary to determine the overall risk of material misstatement for an assertion.

3. **Does the new proposed standard on audit risk describe clearly the relationship between detection risk and substantive procedures?**

No. We do not believe that the relationship between detection risk and substantive procedures is clearly described. While the new proposed standard appropriately explains that the level of detection risk is reduced by performing substantive procedures, it does not describe the interaction between detection risk and other procedures the auditor performs, such as tests of controls, which impact the level of detection risk.

Appendix 2 - Audit Planning and Supervision

4. **Are the proposed requirements for multi-location engagements appropriately aligned with Auditing Standard No. 5?**

Overall, we believe the proposed requirements for multi-location engagements are appropriately aligned with Auditing Standard No. 5. We have one suggestion, however, related to the unpredictability of auditing procedures. Paragraph 14 of the new proposed standard explains that the "auditor should vary the nature, timing, and extent of audit procedures at locations or business units from year to year." In addition to this guidance, we believe it would be appropriate, within the context of multi-location engagements, to include as an example of such unpredictability the concept of varying the location where audit procedures are to be performed from year to year.

5. **Is it clear how the proposed requirements for multi-location engagements would be applied in audits of financial statements only?**

Yes. We believe that the proposed requirements for multi-location engagements, which align with Auditing Standard No. 5, clearly describe how such requirements would be applied in audits of financial statements only.

6. **Are the differences between the responsibilities for supervision of engagement team members and oversight of specialists in accordance with AU sec. 336 appropriate in light of the auditor's responsibilities to opine with reasonable assurance on whether the financial statements are fairly presented, in all material respects, in conformity with the applicable financial reporting framework?**

Overall, we believe the differences between the responsibilities for supervision of engagement team members and oversight of specialists are appropriate. However, we suggest enhancing the guidance by emphasizing the need to communicate the nature, scope, and objectives of the work to be performed by the specialist with engagement team members. Further, we support the Board's current standards-setting project on this topic, to consolidate into one standard all relevant guidance relating to using the work of an auditor's specialist, whether employed or engaged by the auditor.

Appendix 3 - Consideration of Materiality in Planning and Performing an Audit

7. **Are the provisions in the new proposed standard regarding consideration of materiality in multi-location engagements appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?**

Yes. We agree that the provisions regarding consideration of materiality in multi-location engagements are appropriate.

8. **Are the revised provisions regarding reassessment of materiality appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?**

Yes. We agree with the revisions made to the original proposed standard, such that the auditor's reassessment of materiality and tolerable misstatement is made in light of whether changes in circumstances or additional information that the auditor becomes aware of would influence the judgment of a reasonable investor. The discussion in Appendix 9 explains that this revision is intended to encompass situations such as when:

- Changes in laws, regulations, or the applicable financial reporting framework affect investor's expectations about the measurement or disclosure of certain items.
- Significant new contractual arrangements have attracted attention on a particular aspect of a company's business that is separately disclosed in the financial statements.

We believe that these examples are important to the auditor's understanding about how to apply the requirement to reassess established materiality to reflect the broader principal that materiality and tolerable misstatement should be reassessed not only as a result of changes in amounts upon which materiality levels were first based but also on changes in circumstances or information that may affect judgments of a reasonable investor. For this reason, we suggest including these examples in the new proposed standard rather than in an appendix to the release.

Additional Comment

We understand that the Board has considered the comments received on the original proposed standard relating to the use of the term "performance materiality" and decided to retain the term tolerable misstatement because it is well understood by practitioners. We do not agree with the Board's conclusion for two reasons:

1. Both the ISA's and the ASB's clarified risk standards refer to performance materiality in reference to amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. As auditors begin implementing these standards, (the clarified ISAs are effective for periods beginning on or after December 15, 2009 and the effective date for the ASB's clarified Statements on Auditing Standards (SAS), while not yet set, is anticipated to be effective shortly thereafter), this term will become well understood.

   Since almost every registered audit firm will have both public and private company engagements, and since many will also encompass international engagements using foreign auditors, having two terms to describe exactly the same concept makes it unnecessarily cumbersome for audit firms to maintain in policies, procedures and training materials, and will likely result in confusion as to the meaning of the two terms.

2. The term performance materiality is distinguished from tolerable misstatement in both the clarified ISAs and SASs in that performance materiality is used with respect to assessing risks of material misstatement and determining the nature, timing, and extent of further audit procedures, whereas tolerable misstatement is used in the application of performance materiality to a particular <u>sampling</u> procedure.

Therefore, to avoid any confusion about the use of these terms, we strongly recommend that the PCOAB replace the term "tolerable misstatement" with "performance materiality" in the new proposed standard on materiality.

<u>Appendix 4 - Identifying and Assessing Risks of Material Misstatement</u>

9. Does the new proposed standard adequately describe the auditor's responsibilities for performing risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of risks of material misstatement due to error or fraud and to design further audit procedures?

Generally, we believe the new proposed standard adequately describes the auditor's responsibilities for performing risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of risks of material misstatement due to error or fraud and to design further audit procedures.

However, we believe that a fundamental aspect of the objective is missing. To adequately describe the auditor's responsibility, it is essential to describe how such an assessment is to be performed, which is primarily through obtaining an understanding of the entity and its environment, including the entity's internal control. Including this reference within the objective emphasizes its importance in the risk assessment process and corresponds to the prominence of this concept within the standard itself.

10. Are the auditor's responsibilities regarding the additional procedures for understanding the company and its environment in paragraph 11 clear?

No. We believe that the auditor's responsibilities regarding all the procedures for understanding the company and its environment, as set out in paragraph 11, should be clarified by including a reference to paragraph 7 regarding the auditor's responsibility to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. Without such a link, the connection between the auditor's responsibilities and the requirement to consider performing the listed procedures may not be clearly evident and the effectiveness of such procedures may be diminished.

11. Are the proposed requirements regarding obtaining an understanding of internal control over financial reporting appropriate in light of the auditor's responsibilities for identifying and assessing the risks of material misstatement?

Overall, the proposed requirements regarding obtaining an understanding of internal control over financial reporting are appropriate. However, to strengthen the proposed standard, we suggest including a more robust discussion of entity level controls, similar to the discussion in Auditing Standard No. 5, paragraphs 23-24. While we agree with the discussion in Appendix 9 that explains that the objective of an audit of only the financial statements differs from an audit performed under Auditing Standard No. 5, we believe that the auditor's understanding of entity level controls, which add to or potentially mitigate risks of material misstatement, is an essential component of the top-down approach to risk and controls assessment and is essential to the effective performance of any audit, whether or not integrated with an audit of internal control over financial reporting.

12. Are the proposed requirements regarding the discussion among engagement team members about risks of material misstatement appropriate given the auditor's responsibilities for identifying and assessing the risks of material misstatement?

Yes. We believe the proposed requirements regarding the discussion among engagement team members about the risks of material misstatement are appropriate.

<u>Appendix 5 - The Auditor's Responses to the Risks of Material Misstatement</u>

13. Are the proposed requirements for overall responses and responses involving the nature, timing, and extent of audit procedures appropriate given the auditor's responsibility to opine with reasonable assurance about whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?

Generally, we agree that the proposed requirements for overall responses and responses involving the nature, timing, and extent of audit procedures are appropriate. One area where we believe additional clarity is needed, however, is with respect to the factors that may affect the extent of testing a control. Paragraph 31 of the new proposed standard provides a list of factors the auditor should take into account when controls have been tested in past audits, but it is unclear why some of these factors should only be taken into account in these circumstances.

We believe that the following factors listed in paragraph 31 are unique to circumstances when controls have been tested in past audits:

- The nature, timing, and extent of procedures performed in past audits
- The results of the previous years' testing of the control
- Whether there have been changes in the control or the process in which it operates since the previous audit

However, we believe that the other factors listed are not necessarily unique to this circumstance and suggest that the Board reconsider whether such factors should instead be considered in all or many circumstances.

14. Does the new proposed standard clearly describe when tests of controls are necessary in an audit of financial statements only?

We believe the new proposed standard clearly describes when tests of controls are necessary in an audit of financial statements only.

Additional Comment
The objective as set out in paragraph 2 of the new proposed standard appears to be inconsistent with the discussion in paragraph 3. Paragraph 3 explains that to meet the objective of the standard, the auditor must address the risks that are identified and *assessed* in accordance with the new proposed standard, *Identifying and Assessing Risks of Material Misstatement*, whereas the objective in paragraph 2 does not include the notion of addressing the risks "assessed" by the auditor. To address this inconsistency, we recommend that the Board add the clarifying word "assessed" to the objective paragraph.

Appendix 6 - Evaluating Audit Results

15. Does the new proposed standard clearly describe the auditor's responsibilities for accumulating and evaluating misstatements?

We believe the new proposed standard clearly describes the auditor's responsibilities for accumulating and evaluating misstatements. However, we do not believe the new proposed standard sufficiently describes the auditor's responsibility for communicating accumulated misstatements to management on a timely basis to provide them with an opportunity to correct them.

Paragraph 15 of the new proposed standard includes guidance for the auditor to communicate accumulated misstatements to management on a timely basis to provide them with an opportunity to correct them, but the guidance does not require the auditor to request that management correct the misstatements. We believe that the requirement to request management to correct the misstatement is significant and should be included to improve the likelihood that such corrections will be made. Such a requirement is included in paragraph 12 of ISA 450, *Evaluation of Misstatements Identified during the Audit,* and paragraph 7 of the ASB clarified risk standards*, Evaluation of Misstatements Identified During the Audit*.

16. Does the new proposed standard appropriately describe the auditor's responsibilities for evaluating the presentation of the financial statements, including evaluating bias, in light of the auditor's responsibility to opine with reasonable assurance on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?

Yes. We believe the new proposed standard appropriately describes the auditor's responsibilities for evaluating the presentation of the financial statements. In particular, we believe the guidance provided in paragraph 26 of the new proposed standard provides clarity around the impact that bias has on the auditor's evaluation of the effect of uncorrected misstatements and the auditor's assessment of risks.

<u>Appendix 7 - Audit Evidence</u>

17. Does the new proposed standard describe clearly how the auditor should determine the financial statement assertions to use for both integrated audits and audits of financial statements only?

Yes. The financial statement assertions are clearly described in the new proposed standard.

<u>Proposed Amendments to PCAOB Standards</u>

18. Are there provisions in the to-be-superseded standards that should be retained?

We did not note any provisions in the to-be superseded standards that should be retained.

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We appreciate your consideration of our comments and suggestions, and would be pleased to discuss these with you at your convenience. Please direct any questions to Wayne Kolins, National Director of Assurance at 212-885-8595 (wkolins@bdo.com) or Susan Lister, National Director of Audit Policy at 212-885-8375 (slister@bdo.com).

Very truly yours,

/s/ BDO Seidman, LLP

BDO Seidman, LLP

CalPERS

Investment Office
P.O. Box 2749
Sacramento, CA 95812-2749
Telecommunications Device for the Deaf - (916) 795-3240
Phone: (916) 795-3400

March 1, 2010 Via E-Mail: comments@pcaobus.org

J. Gordon Seymour
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street N.W.
Washington, DC 20006-2803

Re: **PCAOB Release No. 2009-007 Rulemaking Docket Matter No. 026**
"Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards"

Dear Mr. Seymour:

I am writing on behalf of the California Public Employees' Retirement System (CalPERS), the largest public pension fund in the United States with approximately $200 billion in global assets and equity holdings in over 9,000 companies. CalPERS provides retirement benefits to over 1.5 million public workers, retirees, and their families and beneficiaries. Acting as fiduciaries to the members of the system, the CalPERS Board of Administration and its staff invest the pension funds of its members over the long term throughout the global capital markets.

CalPERS philosophy is to promote best practices that facilitate integrity in financial reporting. The financial interests of CalPERS beneficiaries are most effectively served in an environment where investors can confidently utilize financial statements to evaluate the risk and reward of an investment. Auditors play a key role in decreasing the risk of material misstatements in financial reports. An effective audit provides the investor with assurance that the financial statements present reliable and valid information which conform to the Generally Accepted Accounting Principles (GAAP). As such, CalPERS supports the Public Company Accounting Oversight Board's mission to reduce audit risk by improving the existing framework for performing audits.

The Public Company Accounting Oversight Board (Board) has reproposed seven auditing standards intended to enhance the effectiveness of auditor's assessment of and response to risk which would be effective for audits of the fiscal years beginning on or after December 15, 2010. The Board has considered comments from issuers, auditors, institutions, regulatory agencies, professional associations and academia in refining the original proposed standards. CalPERS applauds the Board's willingness to engage in open dialogue and incorporate feedback into the proposed standards.

On February 18, 2009, CalPERS responded in support of the Board's efforts to strengthen audit quality. CalPERS endorsed improved requirements related to risk assessment, further integration of the audit of financial statements with the audit of internal control over financial reporting and increased discussion of the auditor's responsibility to consider the risk of fraud during the audit. The response also contained a set of guidelines developed by the Enhanced Disclosure Working Group of The Global Auditor Investor Dialogue to support enhanced disclosures relating to risk controls and the global convergence of best practices. Notably, the reproposal discusses the Board's thoughts on the issues of fraud and convergence in the context of commenter feedback. In this context, CalPERS provides the following:

Fraud

CalPERS is pleased to see that the Board's reproposed standards continue to refine the language addressing areas of interest identified in the aforementioned response letter. Specifically, we continue to emphasize the auditor's responsibilities for considering the risk of fraud during an audit. We continue to support the approach the Board has taken with AU sec. 316, Consideration of Fraud in a Financial Statement and agree that this section will reinforce to the auditor the importance of performing a thorough evaluation of risks of material misstatement due to fraud as an integral part of the audit process.

Convergence

CalPERS commends the Board for presenting a comprehensive comparison of the proposed standards to the analogous standards of the International Auditing and Assurance, the Auditing Standards Board, and the American Institute of Certified Public Accountants. Acknowledging the regulatory constraints of Sarbanes-Oxley, we support a convergence of the existing auditing standards. The global nature of CalPERS investments requires frequent cross-border comparisons of investment opportunities. Harmonized standards promote investor confidence in the quality and comparability of all financial statements. We are pleased to see the reproposed standards have eliminated additional differences between the original proposed standards and the IAASB standards. CalPERS also recommends that the Board continues to thoughtfully pursue the goal of convergence.

As outlined in the "Enhanced Disclosures" [1], CalPERS continues to emphasize the importance of thorough and complete interchange of substantive information between management, the audit committee and the auditor in identifying and assessing the risks of material misstatement and the risk of fraud. Shareowners and investors rely heavily on the audit committee communicating that it has received sufficient, reliable and timely information from management in fulfilling its responsibilities and fiduciary duty to the owners of the company.

Thank you for considering our comments. If you would like to discuss any of these points, please do not hesitate to contact me at (916) 795-9672 or Mary Hartman Morris at (916) 795-4129.

Sincerely,

ANNE SIMPSON
Senior Portfolio Manager
Global Equity

cc: Joseph A. Dear, Chief Investment Officer – CalPERS
Eric Baggesen, Senior Investment Officer – CalPERS
Mary Hartman Morris, Investment Officer – CalPERS

[1] Guidelines for Enhanced Disclosures to Assist Directors, Audit Committees, Shareowners and Investors, April 2009, http://www.enhanceddisclosure.org/pdf/guidelines.pdf.

CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

March 2, 2010

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: Request for Public Comment: *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Related Amendments to PCAOB Standards*, PCAOB Rulemaking Docket Matter No. 026

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants (AICPA). The CAQ appreciates the opportunity to respond to the Public Company Accounting Oversight Board's (PCAOB or the Board) *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Related Amendments to PCAOB Standards* (the reproposal or reproposed standards). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual or CAQ Governing Board member.

Identifying, assessing and responding to risks are integral to the audit process and fundamental to the conduct of high quality audits. We concur with the Board that risk assessment should underlie the entire audit process and result in appropriate audit procedures that are tailored to a company's facts and circumstances, including its size and complexity. As set out in our previous comment letter, we are supportive of efforts to improve auditors' assessment of and response to risks. We have organized our overall observations and comments based on the following:

- Improvements to transparency of the standards-setting process
- Convergence of auditing standards
- Organization and consistency of the PCAOB's standards

- Other comments on the standards-setting process

In addition, we have comments that are specific to each of the seven reproposed standards and the related amendments, which we have included as an Attachment to this letter.

Improvements to Transparency of the Standards-Setting Process

We recognize and appreciate the PCAOB's efforts to increase the transparency of its standards-setting process, including exposing a revised proposal for public comment. In addition, we appreciate the Board's consideration of the feedback from stakeholders on its original proposal and believe that the reproposed standards are significantly improved in a number of areas. For example, we believe the reproposal better integrates and aligns with the principles from PCAOB's Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements* (AS No. 5). In addition, we believe the reproposed standards have been significantly improved not only with respect to their organization but also in the clarity of the underlying requirements.

Further, we recognize and appreciate the Board's efforts to provide its perspectives on the differences between its proposed standards and those of the International Auditing and Assurance Standards Board (IAASB) and the AICPA's Auditing Standards Board (ASB). Comparisons with these standards, combined with the Board's rationale for any differences, provides registered firms and other interested parties with useful insights into the Board's thought process and some insight into its expectations for changes to audit practice. This perspective enhances the ability for commenters to provide thoughtful feedback in response to the Board's proposals, which in turn should enhance the Board's perspective and assist in its efforts to improve audit quality.

While we commend the PCAOB for these measures, we request the Board consider further enhancements to its standards-setting process that would provide additional visibility to the Board's rationale and expectations for changes to practice. We believe these enhancements are consistent with Acting Chairman Daniel L. Goelzer's[1] comments at the December 17, 2009 open meeting whereby he urged "the Board to continue to explore ways of making its standard-setting – and the thinking that underlies its proposals – more open." Suggested enhancements could include the following:

> *Highlight Desired Changes to Practice*
> We note that Board member Charles D. Niemeier[2] suggested at the Board's December 17, 2009 open meeting that the PCAOB, as part of the release of a proposed or final standard or rule, should more clearly express what they expect to change as a result of such standard or rule. We agree and believe that providing specific descriptions of the Board's desired changes to current audit practice as a result of a proposal, final standard or rule would assist auditors and other interested parties in understanding the changes expected from the relevant proposals or standards. We note that the Board could

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[1] See statement of Daniel L. Goelzer at the December 17, 2009 open Board meeting at www.pcaobus.org.

[2] See statement of Charles D. Niemeier at the December 17, 2009 open Board meeting at www.pcaobus.org.

consider the approach utilized by the Financial Accounting Standards Board to provide this information.

In addition, with regards to the comparisons of the PCAOB's proposed standards to those of other standard setters, we note that a large number of registered firms conduct audits in accordance with standards from the PCAOB, ASB and IAASB. As such, given that the PCAOB uses different drafting conventions and terminology than the ASB and IAASB, in situations where the underlying objectives and requirements are similar, firms may infer that the PCAOB does not intend there to be a different auditor action unless it is specifically highlighted by the PCAOB (or otherwise clearly apparent within the context of the standard). As such, we continue to encourage the PCAOB to be as comprehensive in their comparisons as possible to assist firms in recognizing and implementing any intended differences.

Comparison to Original Standards
We note that Board member Charles D. Niemeier[3] also suggested at the Board's December 17, 2009 open meeting that a comparison of proposed standards to existing standards may be more useful than comparisons to standards developed by others. We agree that a comparison to the Board's existing standards conducted, for example, in a paragraph-by-paragraph fashion (where practical), would be very helpful (along with the Board's comparison of its proposed standards to those of the IAASB and ASB). Similarly, in situations where there are significant conforming amendments to existing PCAOB standards (such as, for example, the proposed conforming amendments to AU 316, *Consideration of Fraud in the Financial Statement Audit*) it would be helpful to auditors if the PCAOB provided a copy of the affected standard marked for the proposed amendments. Such comparisons, which are also likely to assist in the development and analysis of proposed standards by PCAOB staff, could be provided as supplemental information accompanying the proposals. These suggested practices would significantly assist commenters' ability to evaluate the effect of the proposal and therefore, improve the quality of their feedback.[4]

We believe that practices such as these would provide additional, helpful transparency to the Board's standards-setting process, facilitate a better understanding of the Board's expected changes to practice, enhance the feedback received by the Board, and encourage more consistent implementation through enhanced clarity – all of which we believe would contribute to advancing the Board's mission to improve audit quality.

Convergence of Auditing Standards

As we have stated in previous comment letters, we fully support the Board's consideration of the work of other standard setters, such as the IAASB and ASB. We recognize that the Board may decide that different procedures are appropriate in the U.S. public company audit environment. However, we encourage the Board

[3] Ibid

[4] We note that such comparisons are published by other audit standard setters for that very reason, and we would encourage the PCAOB to consider such efforts in the future.

to continue to minimize the differences in its standards to only those matters that are unique to audits of issuers in the U.S., as well as encourage the Board to continue highlighting the different procedures required for U.S. public company audits.

As we have previously indicated, we recognize the Board's efforts to provide increased information regarding the Board's rationale for the differences that remain through the Board's responses to the comments received. We also recognize the improvements made to reduce differences between the PCAOB's standards and the International Standards on Auditing (ISAs). For example, we noted a number of areas in which the requirements in the reproposed standards were more closely aligned with the ISAs, including greater consistency with the terminology used by the IAASB. Additionally, we noted that in areas where differences in terminology remained, the Board provided rationale for maintaining the differences. We believe that minimizing differences in language, clearly articulating the rationale for any differences and explaining the expected auditor actions as a result of the differences can serve to enhance auditors' and other interested parties' understanding of the differences between standards issued by each standard setter. Such enhanced understanding will facilitate more consistent application of auditing standards, improve the effectiveness and efficiency of implementing new standards, and improve audit quality. Minimizing differences allows firms, for example, to cultivate synergies related to training, implementation, and the development and maintenance of quality control systems that accommodate the standards of the various standards-setting bodies - all factors that we believe contribute to enhanced audit quality.

However, we believe that the PCAOB should continue to work to further minimize differences between its standards and those of other audit standard setters. We acknowledge the PCAOB's efforts to participate in the work of other standard setters by attending IAASB meetings, inviting the IAASB and ASB Chairs to join the PCAOB Standing Advisory Group (SAG) meetings (as observers with speaking rights), and participating in joint meetings of standards setters. We encourage the PCAOB to continue these efforts, including working collaboratively with the IAASB in the development of standards. We believe that such participation would complement the role of the SAG and the other forums that currently inform the Board's agenda and standards-setting activities. In addition, the other standard setters would benefit from the PCAOB's perspective on current audit issues. Other advantages of participating in such activities include the opportunity for the Board to:

- Hear and participate in discussions among various constituents about potential ways to address issues while preserving the ability and flexibility to obtain perspectives and input through existing practices;
- Minimize and avoid unnecessary differences between the Board's standards and global and U.S. non-public company auditing standards; and
- Provide interested parties with an enhanced understanding of the rationale for differences that remain between the standards.

We believe that such collaboration and dialogue between the PCAOB could have positive effects on the standards-setting process and audit quality.

Organization and Consistency of the PCAOB's Standards

As we noted in our previous comment letter, adoption of these reproposed standards continues the development of a third "style" of PCAOB standards that is inconsistent with the Board's other standards (i.e., interim standards, AS No. 6 and earlier standards) and there is not a clearly stated plan for updating existing standards in the future. Given the PCAOB's recent commitment to an extensive standards-setting agenda, we are concerned that new standards may become increasingly cumbersome to navigate and apply with the remaining interim standards without an overarching framework to guide the development of such standards, as well as a plan for updating existing standards. Therefore, we recommend that the PCAOB consider undertaking a project, similar to that undertaken by the ASB and IAASB, to redraft all of its auditing standards in a consistent manner (e.g., consistent use of objectives), with the intent of encouraging greater understanding and more consistent application. While we recognize that the PCAOB's resources are limited, we believe such a project, and the potential benefits to auditor understanding and performance, merits priority on the Board's agenda.

In the interim, we have noted a number of drafting conventions that we believe may make it more cumbersome to understand and use these reproposed standards. Details of these conventions are included below, including our recommendations to address them:

> *Use of Notes*
> The existence of requirements within notes may make them appear less prominent than if they were placed in the paragraphs of the standards. As a result, we recommend that in situations where the Board is establishing a requirement, that the PCAOB consider placing them in paragraphs, as opposed to notes. .
>
> *Use of Appendices*
> Although we understand that appendices carry the same level of authority as the paragraphs within the standard, the inclusion of requirements within appendices to standards may increase the likelihood that auditors could overlook those particular requirements. Similar to the Board's rationale for incorporating the guidance from the Board's interim standards related to fraud into the respective auditing standards to encourage integration of fraud procedures within the various stages of the audit, we recommend the Board consider incorporating requirements currently located in appendices into the body of the applicable standards.

Other Comments on the Standards-Setting Process

Release Text

As we have previously indicated, we are supportive of the Board's efforts to increase the transparency of the standards-setting process, including efforts to provide its perspective on the differences between its proposed standards and those of the IAASB and ASB, as well as its consideration of comments received. However, we are concerned that in some situations, it appears that in addition to providing insight into the Board's decision-making process, the Board is also attempting to interpret aspects of the standard in the release (e.g., see comment 2c included in the Attachment to this letter). Interpreting standards through release text can result in potential confusion over the requirements within the related standard and result in inconsistent application by auditors. In addition, given that the release is not ultimately part of the final standard, any interpretive guidance contained within it may not be given the same consideration by auditors and other interested parties. Also, to the extent such interpretive guidance is included in the release to a final standard, such guidance could affect commenters' previous understanding of the Board's intent from previous proposals, which not only causes confusion but also may have affected the quality of comments provided to the Board during the public comment process. As a result, we encourage the Board to consider providing such interpretive guidance within proposed standards as opposed to an accompanying release.

Public Involvement in the Standards-Setting Process

In addition to our comments supporting the PCAOB's efforts to increase transparency in its standards-setting process above, we encourage the Board to seek ways to increase the depth and accelerate the timing of public involvement, including the auditing profession, in its standards-setting process. We acknowledge and appreciate the recent efforts the Board has taken to more proactively engage the SAG in standards-setting matters. In addition, consistent with Acting Chairman Daniel L. Goelzer's[5] remarks at the PCAOB's October 21, 2008 open meeting (at which the original proposed standards were approved for exposure) we recommend that the Board consider additional public forums or Board meetings to discuss comments received on a proposal before final adoption of a standard.

We believe the Board could enhance its standards-setting process by establishing external task forces that consist of members with significant expertise (including members of the auditing profession) to participate in developing and updating its auditing standards. We note that the PCAOB utilized a similar model in the development of the PCAOB's *Staff Views of An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies*, which included the input of a working group composed of auditors who had experience with audits of internal control over financial reporting in smaller, less complex companies. In developing this guidance, the PCAOB also consulted with financial executives from smaller public companies.

Establishing external task forces consisting of members with relevant expertise would provide the Board with an opportunity to: 1) obtain public input from interested persons or organizations during the development stage of its standards-setting process; and 2) identify any significant implementation issues prior to the formal publication of a proposed standard for public comment. We also encourage the PCAOB to consider whether field-testing certain proposed standards as part of the Board's overall standards-setting process would provide it with an opportunity to gain insights as to whether the proposed standards result in the Board's intended changes to auditor performance. We believe that such additions to the process would enhance the efficiency and effectiveness of the standards-setting process.

Effective Date

We commend the PCAOB for responding to comments received from the original proposal and including a discussion of the expected effective date in the release to the reproposed standards. With respect to the PCAOB's expectation that the standards would be effective for audits of fiscal years beginning on or after December 15, 2010, we note that such an expectation may be aggressive given the time required to consider public comments received and obtain Board and SEC approval. As we have stated previously, we believe

[5] See statement of Daniel L. Goelzer at the October 21, 2008 open Board meeting at www.pcaobus.org.

that given the foundational nature of the proposed standards, the effective date chosen should provide time required for firms to incorporate the standards into their audit methodologies and training programs prior to implementation, as well as be effective as of the beginning of the audit planning process.

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Enclosed with this letter is an Attachment that provides more detailed comments specific to each of the proposed standards and conforming amendments. As mentioned previously, we appreciate the Board's careful consideration of our comments, its efforts with regards to the reproposed standards, as well as the overall improvements to its standards-setting process. We appreciate the opportunity to comment on the proposed standards and would welcome the opportunity to respond to any questions you may have regarding any of our comments and recommendations.

Sincerely,

Cynthia M. Fornelli

Cindy Fornelli
Executive Director
Center for Audit Quality

Enclosure

cc: PCAOB
Daniel L. Goelzer, Acting Chairman
Willis D. Gradison, Member
Steven B. Harris, Member
Charles D. Niemeier, Member
Martin Baumann, Chief Auditor and Director of Professional Standards

SEC
Chairman Mary Schapiro
Commissioner Luis Aguilar
Commissioner Kathleen L. Casey
Commissioner Troy Paredes
Commissioner Elisse B. Walter
James L. Kroeker, Chief Accountant

Attachment

CAQ Comment #	Appendix 1 – Audit Risk
1a	Paragraphs 9-10 – We note that the reproposed standard could be improved by including certain language currently included in the PCAOB's interim standards related to the concept of detection risk (i.e. paragraph 81 of the PCAOB interim standard AU 319, *Consideration of Internal Control in a Financial Statement Audit*, which states "The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions.") We believe this language could serve to enhance the understanding of the audit risk model and would recommend that the PCAOB consider including it.

CAQ Comment #	Appendix 2 – Audit Planning and Supervision
2a	Paragraph 7 – This paragraph states that the auditor should evaluate whether certain listed matters are important to the company's financial statements and internal control over financial reporting (ICFR) and if so, how they should impact the audit strategy and audit plan. The ninth bullet in the list requires the auditor to consider "preliminary judgments about the effectiveness of internal control over financial reporting." However, unlike the fifth bullet point related to the auditor's preliminary judgments of materiality, this bullet is not clear that it refers to the auditor's judgments. We recommend that the PCAOB modify the ninth bullet point to clarify that it pertains to the <u>auditor's</u> preliminary judgments or consider clarifying the intent behind the omission.
2b	Paragraph 7 – As noted above, this paragraph states that the auditor should evaluate whether certain matters listed are important to a company's financial statements and ICFR and, if so, how they will affect the auditor's procedures. We are not clear how the auditor's actions to "evaluate whether" such matters, as currently drafted, would differ from the requirement in the Board's extant auditing standard (paragraph 3 of AU 311, *Planning and Supervision*) that the auditor "should consider" such matters. Therefore, we recommend the PCAOB consider modifying the language in paragraph 7 to replace "should evaluate" with "should consider" or alternatively, describe any intended difference in auditor performance and documentation requirements.
2c	Paragraphs 11-14 – These paragraphs outline the auditor's responsibilities with respect to multi-location engagements. However, the Board states in Appendix 10 that these provisions "are applicable to all multi-location audits, not just group audits." The Board's existing interim standard (AU 543, *Part of the Audit Performed by Other Independent Auditors)*, is the PCAOB's prevailing guidance with respect to referring to the work of another auditor. The multi-location requirements in paragraphs 11-14, as well as in other reproposed standards, are not clear as to how they are to be applied when another auditor audits the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements – specifically in situations where an auditor refers to the work of another auditor. In addition we note that the Board's standards do not currently contain a definition of a "group audit," nor do the

	standards or the Board's release to the reproposed standards contain any discussion of what the similarities and/or differences between multi-location audits and group audits might be. Therefore, we request the Board to clarify its intent with respect to the application of these paragraphs. (see further discussion in "Release Text" section on page 5 of this letter)

2d	Paragraph 14 – This paragraph appears to create a narrower or more prescriptive requirement than the requirement set forth in paragraph 5c of the reproposed standard, *Auditor's Responses to the Risks of Material Misstatement*, relating to introducing an element of unpredictability in the auditing procedures auditors perform at locations or business units from year to year. Paragraph 14 appears to require auditors to change the nature, timing and extent of audit procedures performed at various locations each year, whereas paragraph 5 requires that auditors incorporate unpredictability and provides varying the locations where procedures are performed as an example of how that might be achieved. We agree with the requirement for auditors to introduce an element of unpredictability in the audit plan. However, we do not believe it is necessary to dictate the specific manner in which the element of unpredictability is to be introduced. Given that the requirement in paragraph 5 is intended to impact the auditor's overall response to the assessed risks of misstatement, including the risk of fraud, we recommend deleting paragraph 14 from this standard or including this paragraph as an example to paragraph 5 of the reproposed standard *Auditor's Responses to the Risks of Material Misstatement*.

CAQ Comment #	Appendix 3 – Consideration of Materiality in Planning and Performing an Audit
3a	As in the original proposal, the reproposed standard uses the term "tolerable misstatement" (e.g., paragraphs 8 and 9), which is different from the term "performance materiality" used in ISA 320 (Revised and Redrafted), *Materiality in Planning and Performing an Audit* for essentially the same concept. As described by the Board in Appendix 9 of the reproposed standards, we recognize that the term is well understood by auditors and that the Board is not seeking to change the concept as described in existing PCAOB standards. However we note that currently, the term is defined and largely understood by auditors in the context of audit sampling (as defined in AU 350, *Audit Sampling*, in the PCAOB's interim standards). Using the same term in two separate fashions – to both assist auditors in assessing risks of material misstatement for the purpose of determining an appropriate audit response and to plan a sample – could result in confusion for auditors and result in misapplication of the concepts, which in turn, could have adverse impacts on audit quality. Therefore, to avoid potential confusion, we recommend that the PCAOB replace the term "tolerable misstatement" in the reproposed standard with "performance materiality," which is the equivalent term used in the ISAs and in the ASB's analogous redrafted proposed standard.

CAQ Comment #	**Appendix 4 – Identifying and Assessing Risks of Material Misstatement**
4a	Paragraph 3 – This standard contains requirements and guidance related to the procedures auditors should perform to identify and assess the risks of material misstatement. Additionally, a significant portion of this standard relates to risk assessment procedures auditors should perform to obtain an understanding of the entity and its environment in order for the auditor to provide himself/herself with a reasonable basis to assess those risks. However, we note that the objective excludes the concept that the identification and assessment of risks are obtained through the auditor's understanding of the company and its environment. As such, we recommend the objective be modified to recognize that the auditor's identification and assessment of risks is "through understanding of the entity and its environment." The addition of this language to the objective will help emphasize how the requirements articulated in the standard are intended to provide the auditor with the requisite understanding of the entity and its environment. Such a clarification would appear to be consistent with the PCAOB's reproposed standard and would also be consistent with the objective of ISA 315, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*.
4b	Paragraph 11 – This paragraph contains procedures an auditor should consider performing as part of obtaining an understanding of the company. We agree that information from such procedures, in many instances, would provide the auditor with meaningful insights into the company and therefore, enhance the assessment of risks. However, we note that the broad nature of the procedures, combined with the presumptively mandatory requirement to consider performing the procedures, may result in auditors expending significant efforts to identify such information and/or documenting the considerations regarding the importance of such information to the auditor's understanding of the company (e.g. observing or reading transcripts of … other meetings with investors…). Such excess efforts may not result in a commensurate increase in audit quality. As such, we recommend the PCAOB consider amending the requirement to indicate that the auditor "might consider" the procedures outlined within the paragraph.
4c	Paragraphs 13 and 68 – Paragraph 13 requires the auditor to identify the "necessary disclosures for the company's financial statements" in identifying and assessing the risks of material misstatement related to omitted or incomplete disclosures. Paragraph 68 states that the "auditor's evaluation of fraud risks…should include evaluation of how fraud could be perpetrated or concealed through omitting or presenting incomplete disclosures." However, the reproposed standards contain no guidance related to the context in which this assessment should be conducted. Therefore, we recommend that the PCAOB clarify that, while the responsibility for identifying "necessary" disclosures resides primarily with management, the auditor's identification, assessment and evaluation of omitted or incomplete disclosures should be conducted in the context of the company's financial reporting framework and the auditor's overall assessment of the risk of material misstatement of the financial statements.
4d	Appendix A5 - The definition of significant risk should make clear that it is the *auditor* who makes a determination of the areas that are deemed significant risk and thus require special audit consideration based on the auditor's assessment of the entity's risks. This concept is excluded from the definition as set forth in Appendix A. We believe the

	definition of significant risk would be enhanced by including the following language: *Significant risk* – A risk of material misstatement that <u>*the auditor determines*</u> requires special audit consideration.
4e	Paragraph 20 – With respect to control design effectiveness, the first Note to paragraph 20 states that “Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.” However, the second Note to this paragraph, which discusses evaluating whether a control has been implemented as designed, does not make the same statement as it relates to evaluating whether a control has been implemented through the performance of a walkthrough. Paragraphs 64-65 (as well as paragraphs 34 and 37 of AS No. 5) appear to indicate that walkthroughs *would* be sufficient for the purpose of evaluating whether a control has been implemented as designed. We agree and, accordingly, we recommend the Board clarify within the second Note to paragraph 20 that a walkthrough would “ordinarily” be sufficient for this purpose.
4f	Paragraph 42 – This paragraph states that “If the auditor has obtained other information relevant to identifying risks of material misstatement through other engagements performed for the company, the auditor should take that into account in identifying risks of material misstatement.” In the release to the reproposed standard, it appears that the Board’s intent was for the auditor to consider and document the effect of *all* engagements performed by the firm when assessing risks. We are concerned that this is a requirement that extends beyond the existing guidance in AU 9311, *Planning and Supervision: Auditing Interpretations of Section 311 and* may result in significant effort without a corresponding benefit to audit quality. Therefore, we recommend that the Board reconsider this requirement. We believe the language included in the PCAOB’s interim standard, AU Section: 9311 provides the appropriate responsibility for considering other engagements performed by the firm; it states the following: “The auditor should consider the nature of non-audit services that have been performed. He should assess whether the services involve matters that might be expected to affect the entity's financial statements or the performance of the audit…” We recommend similar language be included in the reproposed standard.
4g	Paragraph 54 –This paragraph requires auditors to identify other individuals within the company to whom inquiries about their views regarding fraud risks should be directed. We recommend that certain deleted words from paragraph 24 of the PCAOB’s extant AU 316, the source for paragraph 54, be reinstated. Specifically, we recommend making the following changes to the second sentence, “The auditor should identify other individuals within the company to whom inquiries should be directed <u>and determine the extent of such inquiries</u> by considering whether others in the company might have additional knowledge <u>that will be helpful to the auditor in identifying risks of material misstatement due to</u> ~~about~~ fraud, alleged or suspected fraud …” Retaining the extant language will make clear that the auditor is to make a determination about the extent of such inquiries and explicitly relates the need for these inquiries to the risks of material misstatement.
4h	Paragraph 56 – This paragraph sets forth a process for identifying and assessing the risks of material misstatement using the information obtained from the risk assessment

	procedures and other relevant knowledge possessed by the auditor. Paragraph 56d requires auditors to consider the likelihood and magnitude of potential misstatements to assess the possibility that the risk could result in a material misstatement of the financial statements. However, we note that paragraph 56f, which requires auditors to determine whether any of the identified and assessed risks of material misstatement are significant risks, does not contain similar language related to an auditor's consideration of likelihood and magnitude when evaluating whether an identified risk is a significant risk. While the Note to 56f correctly states that the determination of significant risk is based on inherent risk, without regard to the effect of controls, we believe an auditor's evaluation of whether or not a risk is significant when evaluating inherent risk includes consideration of the likelihood and magnitude of the risk of misstatement. As such, we recommend the Board clarify the note to 56f that likelihood and magnitude are factors for consideration in significant risk determinations.
4i	Paragraph 62 – This paragraph contains requirements related to objectives for the auditor to achieve to understand the likely sources of misstatement, including a requirement to identify controls that a company has implemented to address potential misstatements. While these are largely consistent with AS No. 5, we note that in a financial statement audit an auditor ordinarily would only be required to obtain an understanding of controls sufficient to plan the audit. Therefore, we request the Board to consider whether such a requirement significantly enhances the auditor's ability to plan and perform the audit given the potential increase in costs this identification may require, particularly in financial statement audits where auditors may elect not to rely on a company's controls.

CAQ Comment #	**Appendix 5 – The Auditor's Responses to the Risks of Material Misstatement**
5a	Paragraph 2 – The objective as defined appears to be inconsistent with the discussion in paragraph 3. Paragraph 3 clarifies that to meet the objective of the standard, the auditor must address the risks that are identified and *assessed* in accordance with the reproposed standard, *Identifying and Assessing Risks of Material Misstatement*. The objective does not include the notion of addressing the risks "assessed" by the auditor. We recommend that the Board add the word "assessed" to the objective to clarify the auditor's responsibilities. While we support the Board's changes to include the concept of "assessed risk" to create a better linkage to audit responses, we believe that the objective of the standard should include "assessed risk" to make this same linkage.
5b	Paragraph 5 – This paragraph requires the auditor to design and implement overall responses to address the assessed risks of material misstatements. More specifically, item 5c of this requirement entitled "*Incorporating elements of unpredictability in the selection of audit procedures to be performed*" indicates that the auditor should incorporate an element of unpredictability in the selection of auditing procedures to be performed from year to year as part of the auditor's response to the assessed risks of material misstatement due to error and fraud. While we believe that the focus of incorporating an element of unpredictability into the auditor's procedures should be based on the auditor's response to the assessed risks of material misstatement due to fraud, we recommend that the PCAOB consider providing additional clarity regarding its application in response to risks other than fraud risks.

5c	Paragraph 6 – This paragraph requires the auditor to "… evaluate whether it is necessary to make pervasive changes to the nature, timing, or extent of audit procedures to adequately address the assessed risks of material misstatement. Examples of such pervasive changes include performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence." Given the overall requirements of the reproposed standard is to address the risks of misstatement by obtaining sufficient appropriate evidence, we do not believe the term "pervasive" is needed and could result in confusion related to the underlying requirement.
5d	Paragraph 31 – This paragraph provides guidance to assist auditors in determining to what extent evidence obtained in past audits related to the design and operating effectiveness of controls can impact the evidence needed to support the auditor's control risk assessments during the current year audit. While we recognize that this paragraph is largely consistent with the requirements of AS No. 5, we believe it could be interpreted as requiring auditors to evaluate and document their considerations of *all* controls tested in connection with the prior year audit and consequently could result in a significant increase in effort without providing a commensurate benefit to audit quality. We note that the requirement in AS No. 5 is intended to allow the auditor's experience in prior years to inform its assessment of risk, which in turn impacts the nature, timing and extent of testing necessary. As such, we recommend the PCAOB modify paragraph 31 to be consistent with paragraphs 47, 57 and 58 of AS No. 5 to better articulate the requirement.

CAQ Comment #	**Appendix 6 – Evaluating Audit Results**
6a	Paragraph A2 of Appendix A in the reproposed standard defines the word "misstatement;" however due to the sequencing of the sentences, the definition could instead be interpreted as defining "material misstatement." As a result, we recommend that the PCAOB move the second sentence, which deals simply with "misstatement," to the first sentence of the paragraph.
6b	Paragraph 15 – This paragraph includes guidance for the auditor to communicate accumulated misstatements to management on a timely basis to provide them with an opportunity to correct them. Both the IAASB and ASB standards include a requirement that the auditor request management to correct those misstatements and to understand management's reasons, if any, for not making the corrections. We believe that understanding management's rationale for not correcting misstatements could provide the auditor with perspective that could enhance the risk assessment, including the fraud risk assessment. In addition, requiring the auditor to make such a direct and specific request of management may improve the likelihood that such corrections will be made in the current period. As such, we believe this requirement should also exist in the PCAOB standards.
6c	Paragraphs 28 and C1 – Paragraph 28 provides that when evaluating the results of the audit, the auditor should evaluate whether the accumulated results of audit procedures and other observations affect the assessment of fraud risks made throughout the audit and whether audit procedures need to be modified to respond to those risks. This paragraph

	also references Appendix C, which is titled "matters that might affect the assessment of fraud risks." However, paragraph C1 lists matters, if identified during the audit, that "…the auditor should determine whether the assessment of fraud risks remain appropriate or needs to be revised. " This seems to indicate that the auditor is required to determine if each item identified during the audit individually affects the assessment of fraud risks, which appears inconsistent with paragraph 28. We recommend the following sentence replace the first sentence of paragraph C1 in order to be consistent with paragraph 28 and the title of Appendix C – "The following matters might affect the auditor's assessment of fraud risks, including whether that assessment remains appropriate or needs to be revised."

CAQ Comment #	**Appendix 7 – Audit Evidence**
7a	Paragraph 18 – The original proposed standard included a description that "[w]ritten confirmations might be received in paper form, or by electronic or other medium." We note that this description is excluded from the reproposed standard. While we understand the PCAOB is in the process of considering amendments to its interim standard, AU 330, *The Confirmation Process*, we are concerned that the removal of the expectation that confirmations be "written," could have an effect on the auditor's evaluation of information provided from third parties as part of the audit. As such, we recommend that the Board consider re-inserting the word "written" in the first sentence so it refers to a "direct written response." We believe such language would better maintain the existing guidance until the completion of the Board's current project on confirmations.
7b	We note that a number of terms are used in this standard to describe the nature of audit evidence obtained through the audit. For example, the words, "sufficiency", and "appropriateness" are used throughout to describe the characteristics of evidence that auditors are required to evaluate in order to conclude the evidence they have obtained is both sufficient and appropriate to support the related assertion. These terms, however, are not formally defined. We recommend that the Board consider providing formal definitions for these terms, using the guidance in paragraphs 5 and 6 of the reproposed standards, which would allow them to be easily located within the standards as well as promote consistency in performance of audits.

CAQ Comment #	**Appendix 8 – Proposed Amendments to PCAOB Standards**
8a	Proposed amendments to AU 350 – In our comment letter on the original proposed standards, we expressed concern that the suggested amendments to paragraph 23A and 38 of AU 350, *Audit Sampling*, would require auditors who use non-statistical sampling methods to calculate sample sizes using both statistical and non-statistical approaches in all circumstances in order to be in a position to be able to compare the sample sizes and demonstrate that the sample size under the non-statistical method equaled or exceeded sample size under a statistical method. In Appendix 9 of the reproposal, the Board appears to have clarified its view that this was not its intent by stating "[t]he proposed amendments are not intended to require auditors

	to compute sample sizes using statistical methods in all instances to demonstrate compliance with the requirements." Although we appreciate that the Board has attempted to address the concern, we recommend the Board include this guidance within the standard itself to avoid potential confusion or misinterpretation. The potential guidance could leverage the language used in the release or, alternatively, language similar to paragraph A11 of redrafted ISA 530 or footnote 5 from paragraph 23 of the ASB's revised AU 350.

Crowe Horwath

Crowe Horwath LLP
Independent Member Crowe Horwath International

330 East Jefferson Boulevard
Post Office Box 7
South Bend, Indiana 46624-0007
Tel 574.232.3992
Fax 574.236.8692
www.crowehorwath.com

March 2, 2010

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Submitted via email to: comments@pcaobus.org

RE: **PCAOB Rulemaking Docket Matter No. 026, Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards, PCAOB Release No. 2009-007**

Office of the Secretary:

Crowe Horwath LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards (together the "Proposed Standards").

We support the Proposed Standards, and generally believe adoption is an improvement to existing standards. We also believe that adoption may not be difficult as many firms already have in place many of the auditing processes and procedures that are provided in the Proposed Standards. The Proposed Standards will provide value to the users of financial statements by improving consistency in audit services.

However, we believe there are several matters that should be addressed before the Proposed Standards might be adopted. We have provided general observations in the body of this letter, and specific comments on the Proposed Standards in an attachment to this letter. The matters in the attachment are organized by appendix number and paragraph number to expedite your consideration. We provide our observations and comments to assist the Board to better achieve its goals for these Proposed Standards.

Auditor Judgment

The Proposed Standards' effectiveness in operation will largely be determined by the auditor's ability to effectively apply reasoned professional judgment. Audits of financial statements have always required the exercise of judgment. We have seen a recent trend in accounting to move away from prescriptive requirements toward greater use of principles, which require application of judgment, and that trend is also present in auditing standards. The Proposed Standards are improved, but we want to stress the need for emphasis on use of the auditor's professional judgment in assessment of and response to risk. Additionally, risk concepts appropriately allow an auditor to use judgment to determine the resultant testing approach.

We note the auditing standard issued by the PCAOB for audits of internal control over financial reporting emphasizes the need for professional judgment in taking a risk-based approach to performing internal control audits. While the Proposed Standards appear to encourage use of judgment, thus allowing scalability in application, they are still quite prescriptive and detailed. There are likely certain provisions which are now stipulated as requirements that could be made optional depending on the overall needs of the audit, after properly applying auditor judgment.

Convergence of Auditing Standards
Convergence of standards should be a goal in setting auditing standards. We applaud the Board's consideration of the audit risk standards promulgated by other auditing standard setters, including the Auditing Standards Board ("ASB") which has risk related standards already in effect in the United States for non-issuer entities, and the International Auditing and Assurance Standards Board which creates standards commonly used in many other areas of the world. The Proposed Standard includes Appendix 10, "Comparison of Objectives and Requirements of Proposed Auditing Standards to the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants." The ASB may update its risk related standards during its clarity project, but we believe the additional guidance and comparison to the ASB's standards is beneficial to all firms. We applaud the Board's efforts in providing this guidance and comparison.

Another element of convergence is development of a more cohesive body of standards, recognizing that there may be differences required to reflect law, regulation, or regional economic issues. An example of such a difference required by the PCAOB standards is the requirement for audits to report on the effectiveness of internal control over financial reporting. Such differences would be more easily understood and consistently applied if the PCAOB standards were codified into a single set of integrated standards.

* * * * * * * * * * * *

Crowe Horwath LLP supports the Board's efforts to improve its auditing standards with the objective of furthering the public interest. We hope that our comments and observations will assist the Board in its consideration of the Proposed Standards. We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff. If you have any questions on our comments, please contact Wes Williams or Michael Yates at (574) 232-3992.

Cordially,

Crowe Horwath LLP

Crowe Horwath LLP

ATTACHMENT
COMMENTS ON SPECIFIC PROVISIONS OF THE PROPOSED STANDARDS

The following comments are organized by Appendix and Paragraph Numbers in the Proposed Standards.

Appendix 1: Audit Risk
Paragraph 3
Paragraph 3 states that "*the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.*" The focus of our observation is on the phrase "reducing audit risk to an appropriately low level". The Auditing Standards Board of the American Institute of Certified Public Accountants ("ASB") added clarity to this issue by stating "audit risk will be limited to a low level that is, in his or her professional judgment, appropriate for expressing an opinion on the financial statements." In addition, footnote 3 at the end of paragraph 3 refers to AU 230, Due Professional Care. Paragraph 11 of AU 230 (first sentence) states *"reasonable basis for forming an opinion"* versus this paragraph 3 which states *"an appropriate basis for expressing an opinion"*. It is unclear why "reasonable" should be changed to "appropriate". This change combined with the omission of the wording utilized by the ASB makes it unclear as to how to achieve "an appropriately low level".

We encourage the Board to consider adding clarifying language indicating that such a level can be based on auditor judgment.

Appendix 3: Consideration of Materiality in Planning and Performing an Audit
Paragraphs 6-8
Paragraph 6 states – "*the auditor should establish a materiality level for the financial statements as a whole*". Paragraph 7 states – "*The auditor should evaluate whether, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor.*" Paragraph 8 states – "*Accordingly, the amount or amounts of tolerable misstatement should be less than the materiality level for the financial statements as a whole and, if applicable, the materiality level or levels for particular accounts or disclosures.*"

The Proposed Standard would prevent the auditor from using their judgment on differences that may quantitatively exceed the materiality level established but are clearly immaterial from a qualitative perspective, such as a balance sheet reclassification. If a reclassification amount exceeds the materiality established for the audit in paragraph 6, then the Proposed Standard would indicate that it should be reflected in the financial statements. The Board further clarified their position in Appendix 9, paragraph 4 stating - "*The new proposed standard does not allow the auditor to establish a materiality level for an account or disclosure at an amount that exceeds materiality for the financial statements as a whole*". We believe this does not allow the auditor to use appropriate judgment when evaluating individual potential adjustments as well as aggregate potential adjustments. We encourage the Board to review this language and allow the auditor to exercise judgment and due professional care. The ASB addressed this issue in

SAS 107, paragraph 35 as follows: *"To do so, the auditor should determine one or more levels of tolerable misstatements. Such levels of tolerable misstatement are normally lower than the materiality levels."* This phrase would allow the auditor to establish tolerable misstatement higher than materiality, such as for a balance sheet only reclassification when appropriate.

Appendix 4: Identifying and Assessing Risks of Material Misstatement
Paragraph 56

This paragraph sets forth a process for identifying and assessing the risks of material misstatement using the information obtained from the risk assessment procedures (paragraphs 4-55). Paragraphs 4-55 consistently utilize the terminology "risk of material misstatement". However, paragraph 56a states – *"Identify risk of misstatement due to error or fraud using information obtained from the risk assessment procedures (as discussed in paragraphs 4-55) and considering the characteristics of the accounts and disclosures in the financial statements."* The original proposal had the word "material" inserted before "misstatement" in that phrase, which would be consistent with paragraphs 4-55. By eliminating the word material from paragraph 56a, auditors appear to be required to identify many more risks present in an audit that are not material, and to perform the detailed evaluation process outlined in 56a-56e. We believe insertion of the word "material" is needed.

Appendix 5: The Auditor's Responses to the Risks of Material Misstatement
Paragraph 45

This paragraph provides guidance on procedures that should be performed if information is substantively tested at an interim date. The paragraph clearly indicates the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. We believe this statement provides sufficient guidance and direction to the auditor while recognizing the auditor needs to exercise judgment on the sufficient appropriate audit evidence to gather to extend their conclusion from interim to period end. The Board included specific requirements to the above guidance by stating in the last sentence: *"Such procedures should include (a) comparing relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual and investigate such amounts, and (b) performing audit procedures to test the remaining period."* Requirements (a) and (b) make it clear that substantive analytics (step "a") from interim to year end alone are not sufficient and that the auditor would be required to perform other audit procedures (step "b") in order to conclude. We believe this concept is not fully formed, and that the auditor should be able to determine the sufficient appropriate audit procedures necessary to extend their conclusions from interim to period end. We recommend the deletion of the last sentence in paragraph 45 or alternatively, develop the extensive guidance necessary to adequately provide the options available.

Deloitte & Touche LLP
Ten Westport Road
P.O. Box 820
Wilton, CT 06897-0820
USA

www.deloitte.com

March 2, 2010

Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Request for Public Comment on Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards (PCAOB Release No. 2009-007, December 17, 2009, Rulemaking Docket Matter No. 026)

Deloitte & Touche LLP appreciates the opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") on its *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (PCAOB Release No. 2009-007 ("Release"), December 17, 2009, PCAOB Rulemaking Docket Matter No.026) (the "Proposed Standards").

We continue to support the PCAOB's efforts to improve its auditing standards related to the auditor's identification of, and responses to, risk in the conduct of an audit. The risk assessment standards contain many of the core principles underlying the audit and the PCAOB has advised that they will be used as a foundation for the development of other auditing standards. Given their importance to the auditing standards as a whole, we believe transparency in the process undertaken by the PCAOB to develop the risk assessment standards is essential. To that end, we commend the PCAOB for its decision to revise and re-expose for public comment the Proposed Standards following their original proposal in 2008. We note several improvements to the Proposed Standards arising from the revisions made by the PCAOB. However, there are certain elements of the Proposed Standards with which we continue to be concerned and therefore we have carried forward certain comments from our comment letter on the original proposed standards. We have also included new comments based on revisions proposed by the PCAOB. Our letter contains Overall Comments and Specific Comments on Proposed Standards by Paragraph.

We welcome an opportunity to further discuss these matters with the Board and the staff. Dialogue with commenters as the Proposed Standards are evaluated and changes are considered will facilitate a more complete understanding of the comments, full consideration of related implications, and, we believe, will ultimately improve the final standards and the auditor's ability to implement them effectively and efficiently. If you have any questions or would like to discuss these matters further, please do not hesitate to contact John Fogarty at (203) 761-3227. We thank you for your consideration of these matters.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: Daniel L. Goelzer, Acting PCAOB Chairman
Bill Gradison, PCAOB Member
Steven B. Harris, PCAOB Member
Charles D. Niemeier, PCAOB Member
Martin F. Baumann, Chief Auditor and Director of Professional Standards

Mary L. Schapiro, SEC Chairman
Luis A. Aguilar, SEC Commissioner
Kathleen L. Casey, SEC Commissioner
Troy A. Paredes, SEC Commissioner
Elisse B. Walter, SEC Commissioner
James L. Kroeker, SEC Chief Accountant

Table of Contents

I. Overall Comments

We agree with the Board's statement that these Proposed Standards "…address many fundamental aspects of the audit process and are expected to serve as a foundation for future standard setting…" Given the foundational nature of the Proposed Standards and as the PCAOB is embarking on its active standard-setting agenda, we would like to take this opportunity to provide more general input to the PCAOB on certain overarching aspects of its standard-setting processes, including the structure and format of its auditing standards.

Within the context of our general comments on the standard-setting processes, we have provided examples of our points in relation to the Proposed Standards. Our Overall Comments include feedback on:

A. Transparency in the standard-setting process

B. Drafting conventions employed by the PCAOB in its auditing standards, including:

1. The structure of standards and releases
2. The use of terminology throughout the auditing standards
3. The application of Rule 3101
4. Documentation requirements
5. The integration of requirements and guidance related to multi-location engagements in the Proposed Standards

C. Convergence with other auditing standard-setting bodies

D. Standard-setting agenda, timetable, and effective date

A. Transparency in the standard-setting process

The re-exposure of the Proposed Standards is one of several steps that we have noted the PCAOB has taken towards increasing the transparency of its standard-setting process. We are encouraged by the PCAOB's objective, stated in its 2009 – 2013 Strategic Plan, to "maintain a program to obtain input from investors, public companies, registered public accounting firms, the academic community and other interested parties on the PCAOB's proposals and emerging issues related to its work" through "[e]nhanc[ing] the transparency of standard setting and other rulemaking initiatives by developing clear releases and other statements describing the objectives, methods and intent of each proposal in a manner that allows the investing public and other interested parties to understand the import and effect of the proposal and facilitates meaningful public comment."

We strongly support the inclusion of Appendix 9, *Additional Discussion of New Proposed Auditing Standards and Comments on Original Standards Proposed in October 2008* ("Appendix 9"), and Appendix 10, *Comparison of the Objectives and Requirements of Proposed Auditing Standards to the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants* ("Appendix 10"), in the Release. We believe the inclusion of these appendices marks a positive step for the PCAOB in meeting its 2009 – 2013 Strategic Plan objectives for transparency. Appendices such as these provide an opportunity for the PCAOB to clearly describe the rationale for the structure and content of its Proposed Standards. At the same time, we believe that transparency would increase and usefulness would improve if a greater level of detail were provided in these appendices. In particular, the appendices should set forth the reasoning for the differences between the original proposed standards and the Proposed Standards. Importantly, the appendices should clearly describe the details and rationale for the differences between the Proposed Standards and the risk assessment standards in the International Standards on Auditing (ISAs) of the International Auditing and Assurance Standards Board (IAASB) and the Statements on Auditing Standards (SASs) of the Auditing Standards Board (ASB), which have been implemented by many public accounting firms.

Board Member Niemeier indicated during the open meeting to approve the Proposed Standards for public comment, "[w]e should use our releases to explain what we want to change. This would help auditors understand our expectations."[1] We agree with this statement and we believe that the Release, including Appendices 9 and 10, could have more clearly articulated the expected changes in practice arising from the Proposed Standards.

For example, Appendix 9 describes a change made to the discussion of the concept of materiality in Appendix 3, *Consideration of Materiality in Planning and Performing an Audit*. In the PCAOB's existing standard and in the original proposed standard of the same name, the concept of materiality was linked to FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information.* In the Proposed Standards, the concept of materiality has instead been linked to case law and the Supreme Court's articulation of the concept of materiality. In Appendix 9, only very limited explanation is provided for the revision, and it does not appear that the change arose due to comments received on the original proposed standards. More importantly, there is no indication of whether the PCAOB expects any change in practice from this revision, or whether it views the concept of materiality as being significantly different between case law and the applicable accounting frameworks used by issuers whose financial statements are being audited in accordance with the PCAOB's standards.

We also note that Appendix 10 is incomplete for several reasons:

- The appendix provides a high-level comparison between the Proposed Standards (in full) and the objectives and requirements sections of the IAASB and ASB's respective risk assessment standards. This results in an "apples to oranges" comparison, as it excludes the application material that is included in the IAASB and ASB's standards. Such application material is considered an essential part of the IAASB and ASB standards. Auditors are required by the IAASB and ASB standards to have an understanding of the entire text of a standard (including the application material) so as to be able to apply the related requirements properly. For future such appendices, we believe a more comprehensive comparison of complete standards (i.e., objectives, requirements, and guidance, including application material) would be appropriate.
- Even for the components of the ISAs that are covered in Appendix 10 (i.e., objectives and requirements), the appendix does not include all differences between the Proposed Standards and the standards of the IAASB and ASB.
    - For example, the wording of the second bullet of paragraph 10 in Appendix 2, *Audit Planning and Supervision* ("Appendix 2"), differs from the corresponding wording in ISA 300, *Planning an Audit of Financial Statements* ("ISA 300") paragraph 9. In

[1] See Statement by Board Member Charles D. Niemeier at the December 17, 2009, open Board Meeting on http://www.pcaobus.org.

the ISA, the auditor is required to include in the audit plan a description of "the nature, timing and extent of planned further audit procedures at the assertion level." In paragraph 10 of Appendix 2, the auditor is required to include in the audit plan a description of "the planned nature, timing and extent of tests of controls and substantive procedures" without mention of doing so at the assertion level. This difference is not discussed in Appendix 10 and therefore it is unclear (1) whether a difference is intended by the PCAOB and (2) what expected difference in practice, if any, is intended as a result of the divergence.

  - For example, paragraph 16 of Appendix 6, *Evaluating Audit Results*, differs from the corresponding wording in paragraph 7 of ISA 450, *Evaluation of Misstatements Identified During the Audit*. Paragraph 16 of Appendix 6 indicates that if management has corrected an account or disclosure, the auditor "should evaluate management's work to determine whether the corrections have been appropriately recorded and whether uncorrected misstatements remain." Paragraph 7 of ISA 450 indicates that the auditor "shall perform additional audit procedures to determine whether misstatements remain." This difference is not discussed in Appendix 10 and therefore it is unclear (1) whether a difference is intended by the PCAOB and (2) what expected difference in practice, if any, is intended as a result of the divergence.

- There is no overall commentary from the PCAOB about whether the differences included in Appendix 10 are, in the PCAOB's view, the only substantive, intended differences between the ISAs and SASs and the Proposed Standards, or whether there are other differences that the PCAOB has chosen not to highlight but for which they expect a difference in practice.

As noted above, we believe comparative appendices can be extremely useful in highlighting the intended differences between the PCAOB's proposed standards and the analogous standards of the IAASB and ASB.

In addition, and equally important, these appendices should be used to describe in detail the differences between the existing PCAOB standard and the proposed PCAOB standard. This will contribute to a higher level of audit quality, where the auditor can clearly determine what actions to take that are different or additional when performing the audit in accordance with the standards of the PCAOB. We also recommend that as the PCAOB continues to move forward with its standard-setting agenda it would be useful when seeking public consultation on its proposed standards to provide "marked changes" versions, showing changes from the existing PCAOB standards. This will enable commenters to quickly identify and understand the changes proposed by the PCAOB, particularly with respect to significant conforming amendments (such as those proposed with respect to AU 316, *Consideration of Fraud in a Financial Statement Audit* ("AU 316")). Such information will enable the PCAOB to highlight in the information accompanying the proposed standards (1) the reasons for those changes and (2) the expected changes in practice.

In addition to the transparency initiatives manifested in the re-exposure of the Proposed Standards, we also recognize other activities the PCAOB has undertaken to more holistically address transparency in its standard-setting processes. Most notably, the organization and structure of the PCAOB's last Standing Advisory Group (SAG) meeting in October 2009, which included a discussion of comments received on the original proposed risk assessment standards, demonstrated the PCAOB's efforts to foster a two-way dialogue with the SAG about auditing standards while the standards are in the process of being developed. We also encourage the PCAOB to consider increasing the use of task forces comprised of audit practitioners for future standard-setting activities; similar to the task force used when developing the PCAOB's *Staff Views: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies.*

B. Drafting conventions employed by the PCAOB in its auditing standards

We remain concerned about the drafting conventions used in the PCAOB's auditing standards, including, in particular, the use of terminology. We believe improvements need to be made in order to more clearly communicate the PCAOB's expectations of auditors, enhance the usability of the standards, and improve their application. It is imperative for auditors to have a clear understanding of the standards in order to be able to apply them. We believe the PCAOB could significantly improve the understanding and application of its standards in several ways, discussed below.

1. Structure of standards and releases

In general, we find the Proposed Standards to be cumbersome and difficult to follow. One cause of this reaction is the placement of requirements in any and all areas of a standard, or in some cases, within appendices or the Release accompanying the standard. Such an approach may lead to reduced audit quality as auditors have to spend time conducting a comprehensive search through sizable Releases to ensure they have documented compliance with each "should" and "must" in the standard itself as well as the accompanying Release.

Within a standard, specific requirements are set forth in multiple locations including in a Note, Appendix or a footnote. We believe that the "peppering" of requirements throughout a standard is not the most effective way of identifying and communicating requirements to auditors.

The intention of a "Note" is unclear. Some readers may think they are of less importance (i.e., like a footnote or an aside). Other readers may believe that they are being used to highlight significant points. It is difficult to determine the reasoning and circumstances under which Notes are employed by the PCAOB in its standards. Unless the PCAOB intends to draw specific attention to the content of a Note, we believe it would be clearer to include the content of Notes within the text of the underlying paragraph itself.

In addition, we believe it is inappropriate and confusing for the PCAOB to use "should" and "must" statements outside of a standard. For example, in the Release accompanying the Proposed Standards, Appendix 9 discusses the requirement included in Appendix 6, *Evaluating Audit Results* for the auditor to identify necessary disclosures for the company's financial statements. We agree with the requirement, but page A9-30 of the Release indicates that "[t]his requirement **should** prompt auditors to be more thoughtful and thorough in their approach to testing and evaluating disclosures." Rule 3101 *Certain Terms Used in Auditing and Related Professional Practice Standards* ("Rule 3101"), which we discuss further below, sets forth the use of "should" and "must," and their use in the Release as described above is confusing. We are unsure whether the auditor now has an incremental and presumptively mandatory obligation to be "more thoughtful and thorough."

Overall, we believe a clearer approach would be to use a structure similar to the ISAs, with requirements:

- Only included within a proposed standard and not included in a Release or Appendices accompanying the proposed standard;

- Clearly identified in accordance with PCAOB Rule 3101;
- Properly labeled and included in one location within the standard and followed by clearly labeled guidance.

We believe that the ISA structure provides a much clearer orientation to objective, requirement, and guidance so that the auditor can more easily locate and understand the requirements and implement the required auditor actions. We do not see how the structure of the PCAOB standards enhances readability or understanding in comparison to the ISA structure, and are in fact concerned that readability and understanding may be diminished by the PCAOB's structure. To the extent the PCAOB believes that its structure is more understandable and clearer than the ISA structure, it would be beneficial to communicate its rationale to the users of its standards, including addressing the specific concerns we have highlighted.

2. Use of terminology throughout the auditing standards

We continue to have several concerns about the terminology employed in the Proposed Standards. Because the terminology decisions made for the purposes of the Proposed Standards will affect future standard-setting activities, the finalization of the Proposed Standards is the appropriate time to develop a set of guidelines for the PCAOB to follow for using certain terms (such as "assess," determine," "establish," and "evaluate"). Such guidelines should also address the appropriate circumstances when individual terms should be used (e.g., establishing the circumstances under which it would be appropriate to use "determine" versus "evaluate" versus "conclude"), for using the present tense (i.e., when providing a statement of fact and not when describing a required auditor action in accordance with Rule 3101), and for using conditional language such as "ordinarily" and "usually." These guidelines should be consistently employed in drafting standards so that auditor's performance requirements and expectations are clear. In developing and applying such guidelines in the standard-setting process, the Board should consider the implications of the language chosen, including the resulting audit performance intended and the related documentation requirements. Clear requirements and expectations will result in an improvement in audit quality.

Our concerns relating to terminology in the Proposed Standards fall into three principal categories:

a. It is difficult to determine whether differences in terminology with the ISAs represent intended differences in the application of requirements. For example,

- Appendix 4, *Identifying and Assessing Risks of Material Misstatement* ("Appendix 4"), defines "significant risk" as "a risk of material misstatement that requires special audit consideration." In ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, the definition of "significant risk" is "[a]n identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration." The PCAOB's proposed definition does not refer to "identified and assessed" risks, but rather only refers to "risks." The resulting implications are unclear, particularly as the difference in the definitions of the term is not addressed in Appendix 10. The concept of the auditor's risk assessment process is that the auditor identifies and then assesses significant risk, and then plans the audit procedures according to the "identified and assessed" risks. To remove these descriptors from the definition results in the auditor's risk assessment process apparently becoming disconnected from the planned audit procedures and is contrary to the fundamental premise that the auditor's risk assessment forms the basis for the auditor's procedures. We believe the definition of "significant risk" should use the phrase "identified and assessed" risk. If the PCAOB decides not to use the phrase, we would like to understand whether the PCAOB believes the difference in terminology represents a substantive difference, and, if so, an explanation of the purpose of the difference should be provided in Appendix 10.

- Appendix 6, *Evaluating Audit Results*, includes a requirement in paragraph 3 for the auditor to "take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements." ISA 330, *The Auditor's Responses to Assessed Risks*, paragraph 26 contains the exact same requirement, but instead of using "take into account" the auditor action is to "consider." This is another example of a difference in terminology with the ISAs, where the impact is unclear. We have concerns about the meaning and intended action that is meant to result from a requirement to "take into account", which we discuss further below, and additionally we are not clear what level of documentation is expected to support fulfillment of such a requirement. In addition to these general concerns, the rationale for the difference between the Proposed Standards and the ISAs is not provided in Appendix 10; therefore, we are unable to determine whether a difference in practice is in fact intended.

There are many other examples throughout the Proposed Standards of use of different terminology than the corresponding ISA paragraph(s) where the differences are neither noted nor explained as intending to mean something different. One area of specific concern regarding these wording changes is the impact in situations where a non-U.S.-based auditor familiar with, and experienced in, applying the ISA requirements is required to apply the standards of the PCAOB. Without a clear indication of whether the auditor is expected to perform different or incremental procedures because of the different language in what could reasonably be construed to be the same requirements, unnecessary confusion may ensue, which will potentially adversely affect audit quality, may result in more costly audits, and foster disagreements or misunderstandings when audits are inspected.

b. Terminology changes made in the Proposed Standards may not have flowed through to other PCAOB auditing standards. For example,

   - In the conforming amendments detailed in Appendix 8 *Proposed Amendments to PCAOB Standards*, we note that certain terminology changes were made to other PCAOB standards, but we are concerned that these changes may not have been comprehensively implemented across the PCAOB standards. For example, a conforming amendment was proposed to paragraph 2 of AU 310, *Appointment of the Independent Auditor*, to replace the term "assistants" with "engagement team members." We agree with the proposed change. However, paragraph 2 of AU 310 includes a reference to AU 210, *Training and Proficiency of the Independent Auditor*. Paragraph 3 of AU 210 uses the term "assistant." There is no conforming amendment proposed to change "assistant" in AU 210. Paragraph 3 of AU 210 also uses the term "subordinates" in reference to engagement team members, but no conforming amendment is included to change that language.

- Similarly, the use of "auditor," "engagement partner," and "engagement team" seems inconsistent throughout the Proposed Standards as well as the existing standards. In Appendix 2, paragraph A2 defines "engagement partner" as a member of the engagement team, but paragraph 22 of that appendix states that "the auditor should properly supervise the members of the engagement team." Further, paragraph 50 of Appendix 4 states that the "auditor should emphasize the following matters to all engagement team members." In both these examples, it is unclear whether the "auditor" is intended to refer to a different individual than the "engagement partner." The relationship of the "auditor" to the engagement team, and the resulting implication of these terminology differences, if any, is also not clear.

As the PCAOB continues over time to revise its auditing standards, we believe it would be useful to develop guidance regarding the terms used therein to assist individuals in understanding the different terms used and to recognize when there is meant to be equivalence between old and new terminology. In the context of the Proposed Standards, we recommend that the PCAOB implement conforming amendments to reconcile the language of its existing standards to the language of the Proposed Standards as completely as possible.

c. The intended meaning of certain auditor actions is unclear. For example,

- The Proposed Standards include a number of requirements for the auditor to "take into account" and to "consider" (e.g., Appendix 5, paragraph 9(b) and Appendix 4, paragraph 11, respectively). Appendix 9 indicates that the use of "take into account" is not new. However, we note that the term is used in very limited circumstances in the interim standards adopted by the PCAOB on April 16, 2003. The extent of its use in the PCAOB's standards increased significantly when Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* ("AS 5") became effective. In describing the difference between a "consider" requirement and a "take into account" requirement, Appendix 9 explains that "consider" is used "only when referring to a requirement to consider performing an action or procedure." "Take into account" seems to be used more broadly and with varying meanings in the Proposed Standard, which we believe will lead to confusion, inconsistent application, and as a result will likely have an adverse impact on audit quality.
    - For example, paragraph 55 of Appendix 4 states: "[w]hen evaluating management's responses to inquiries about fraud risks, the auditor should take into account that management is often in the best position to commit fraud in determining when it is necessary to corroborate management's responses." The use of "take into account" in this sentence is confusing in three ways.
        - First, the statement itself that management is often in the best position to commit fraud is factual, and therefore we do not believe wording the statement as a presumptively mandatory requirement is appropriate.
        - Secondly, in accordance with the discussion in Appendix 9 about when it would be appropriate to use "consider," it would seem that in this paragraph the intent is that the auditor is required to consider whether to perform an action or procedure (i.e., the auditor is determining whether it is necessary to corroborate), so if a requirement is warranted here,

"consider" may be more in line with the explanation provided in Appendix 9.

- Finally, we believe that, as drafted, the use of the phrase "take into account" questions the utility of discussing fraud with management because it may be management that committed the fraud. We believe that fraud can in fact come to light by asking direct questions of management.

We suggest that this sentence be revised along the lines of a similar statement in ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph A17: "Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information."

- For example, paragraph 9 of Appendix 2 indicates a list of items the auditor "should take into account" in establishing the overall audit strategy (e.g., the reporting objectives of the engagement). In the analogous ISA paragraph (ISA 300, paragraph 8), the required actions are detailed on an item-by-item basis (identify the characteristics; ascertain the reporting objectives, etc.). In this case, use of "take into account" in the Proposed Standards seems to be used as a substitute for clearer auditor actions (identify, ascertain, etc.), as well as for "consider." We recommend that the requirements of paragraph 9 in Appendix 2 be aligned with the auditor actions specified in ISA 300, paragraph 8.

3. The application of Rule 3101

As expressed in our comment letter on the original proposed standards, we continue to be concerned with how the Proposed Standards are drafted in light of Rule 3101 and the impact of such drafting on auditor performance. We believe the Board should evaluate its application of Rule 3101 in the Proposed Standards in light of intended auditor action.

Under the Board's Rule 3101, the auditor is required to fulfill specific responsibilities within an auditing standard based on use of the words "must" or "should" (i.e., an "unconditional" or a "presumptively mandatory" responsibility, respectively).[2] In order for the auditor to demonstrate that he or she has fulfilled these responsibilities, and to comply with Auditing Standard No. 3, *Audit Documentation* ("AS 3"), he or she must have appropriate documentation within the working papers demonstrating what procedures were performed relative to each instance of a "must" or a "should."

[2] PCAOB Rule 3101, sets forth three degrees of auditor responsibility based on the word usage in PCAOB audit standards as follows:

- *Unconditional Responsibility:* The words "must," "shall," and "is required" indicate unconditional responsibilities. The auditor must fulfill responsibilities of this type in all cases in which the circumstances exist to which the requirement applies.
- *Presumptively Mandatory Responsibility:* The word "should" indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type specified in the Board's standards unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard.
- *Responsibility to Consider:* The words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility to consider.

We recognize that in developing the Proposed Standards, the PCAOB has responded to comments received on the original proposed standards that point out the risk that lists of presumptively mandatory requirements would detract from audit quality, create a "check the box" mentality, and impede auditor judgment. The PCAOB eliminated certain presumptively mandatory requirements that were redundant, and some that preceded various lengthy lists of considerations and activities. However, in place of the presumptively mandatory requirements, the present tense has been used, which in some ways is potentially more detrimental to understandability than additional requirements (i.e., it is now not clear whether a requirement is being created or not).

For example, Appendix 4, paragraph 7 requires the auditor to obtain an understanding of the company and its environment. Following that requirement is a statement that: "Obtaining an understanding of the company includes understanding the following:" followed by a list of factors. In the original proposed standards, there was a requirement for the auditor's understanding to include the factors. We believe that in making this change the PCAOB intended to eliminate the presumptively mandatory requirement; however, the use of the present tense is hard to interpret. In Appendix 9 (page A9-27), the PCAOB discusses the "expansion of requirements" related to obtaining an understanding and states: "The necessary understanding…includes the following." There is also a footnote indicating similar "provisions" within the Proposed Standards that have been revised. We are not familiar with the concept of "provisions" and their relationship to presumptively mandatory and mandatory requirements. The explanation in Appendix 9 may be read by some to indicate that the requirement in the original proposed standard still exists, albeit worded in the present tense. Others may conclude that because Rule 3101 is not being employed, then the list of factors is provided as guidance and the auditor may use his or her judgment to determine which factors to include in his or her understanding of the company and its environment. In any event, the use of present tense to describe auditor actions results in a lack of clarity about the intended meaning.

We are concerned that writing standards with unclear application of Rule 3101 will significantly affect audit quality and how audit work is assessed by the PCAOB (through its inspection process) and others (e.g., in the litigation context). Using the present tense, including the phrase "needs to be", creates ambiguity and confusion as to what is required, as it is not clear how such phraseology fits into the Rule 3101 framework, and the auditor procedures to be performed.

4. Documentation requirements

We noted that the conforming amendments of the Proposed Standards included proposed revisions to AS 3 to incorporate specific documentation requirements arising from the requirements of the risk assessment standards. As the PCAOB continues its standard-setting agenda, it would be helpful to understand the PCAOB's intentions regarding documentation requirements specific to individual standards. In particular, the PCAOB should determine whether it will continually amend AS 3 to add individual documentation requirements as standards are developed or revised, or whether requirements specific to a particular standard will be located in that standard, as is the approach of the IAASB and ASB. We believe it may be confusing to users of the PCAOB's standards to contend with a continually updated AS 3, and we therefore recommend the PCAOB adopt an approach similar to the IAASB and ASB. We believe setting forth the overarching requirements related to documentation in one place (AS 3) and then reflecting the application of those requirements in the specific context of individual standards would best assist the auditor in meeting the objectives of the individual standards.

5. *The integration of requirements and guidance related to multi-location engagements in the Proposed Standards*

We note that the PCAOB has included certain requirements related to multi-location engagements in the Proposed Standards. On an individual requirement level, we agree with each of the requirements, subject to certain comments in our Specific Comments by Proposed Standard set forth below. However, the PCAOB's 2010 standard-setting agenda as communicated at the October 2009 SAG meeting includes a principal auditor project, which we assume means a revision to, or replacement of, AU 543, *Part of Audit Performed by Other Independent Auditors*. Further, ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*, is effective for periods beginning on or after December 15, 2009. Given all of the current and planned activity related to the execution of multi-location engagements, it is difficult to judge the small number of individual requirements inserted into the Proposed Standards without having the fuller picture of the PCAOB's intentions related to auditing standards for multi-location engagements more generally.

For example, in discussing the multi-location requirements added to Appendix 2, *Audit Planning and Supervision*, Appendix 10 includes a statement that "the provisions in the proposed standard are applicable to all multi-location audits, not just group audits" which we found confusing. We believe that in most circumstances multi-location audit engagements would be considered group audits. It is unclear whether the PCAOB intends to develop a whole standard related to the special considerations related to performing group audits, as has been done by the ASB and IAASB, or whether it intends to include limited requirements in various standards related to multi-location engagements and then revise AU 543 related to the use of the work of another auditor. We believe that the PCAOB should develop a comprehensive standard related to the performance of a group audit holistically (and, if necessary, provide guidance related to its distinction of a group audit from a multi-location audit). We believe the PCAOB should use ISA 600 and the proposed SAS, *Audits of Group Financial Statements (Including the Work of Component Auditors)*, as starting points for the PCAOB's standard.

C. Convergence with other auditing standard-setting bodies

In previous communications with the PCAOB, we have expressed our support for the PCAOB's convergence of its auditing standards with the standards of the IAASB and the ASB. We take this opportunity to again communicate our strong support for convergence.

As we have noted in the past, the Board's consideration of the work by other standard setters is critically important in enhancing the effectiveness and efficiency with which standards are widely understood, implemented, and applied. This is particularly true for multi-location engagements where portions of the work are performed outside the U.S. jurisdiction.

We acknowledge there will be specific areas where the Board believes different requirements are needed for purposes of conducting an audit of a U.S. public company and, as such, we appreciate that the auditing standards of the PCAOB cannot be carbon copies of the ISAs. However, we believe that, in both form and substance, the auditing standards of the PCAOB could converge with the ISAs in many areas. The ISAs are used worldwide as the basis for the majority of public company audits conducted. The standards are developed by a board composed of practitioners and non-practitioners, with key regulators (including the PCAOB) invited to participate, with speaking rights, at the IAASB's meetings where the ISAs are developed. The ISAs are subject to due process and public consultation as they are developed. In addition, a significant number of auditing firm networks (including the largest networks) use the ISAs as the basis for their global audit policies and methodologies, supplemented as local auditing standards and regulations necessitate.

We believe the PCAOB has the opportunity to effectively and efficiently leverage the work completed by the IAASB and the ASB, and we therefore strongly encourage the PCAOB to use the ISAs as a starting point for the revision of its standards. We do not believe that compelling reasons exist for the PCAOB not to do so.

Converging with the structure of the ISAs and SASs would primarily entail:

- Including an objective in each standard (which we are encouraged to see the PCAOB doing in the Proposed Standards, as we believe objectives are useful in providing context for understanding the requirements of the standard);
- Locating requirements in one section of a standard with a clear identifying heading and using appropriate terminology to establish requirements that are outcome-based auditor actions, followed by sections of guidance that assist the auditor in understanding and implementing the requirements;
- Using the same definitions and terminology as the IAASB and ASB, unless a purposeful change is intended, and in those cases clearly communicating the rationale for such changes and the resulting difference in intended application.

As noted above, we understand that there may be valid reasons for differences between the standards of the PCAOB and the IAASB and ASB standards (i.e., arising from differences in facts and circumstances pertaining to audits of public companies in the U.S). However, for those concepts and requirements that would apply regardless of the jurisdiction or listing status of the company, we believe the PCAOB should converge with the standards of the IAASB and ASB. We believe this is consistent with the PCAOB's view to "eliminate unnecessary differences between the Board's risk assessment standards and other risk assessment standards" as expressed in the release accompanying the original proposed standards. Further, we believe that minimizing differences will help facilitate cross-border cooperation and effectiveness.

We note that the Board did eliminate certain unnecessary differences in the Proposed Standards. However, we believe that the Proposed Standards continue to retain unnecessary differences in form, structure, and content, and we urge the Board to eliminate these remaining differences. We therefore recommend that the PCAOB commit to having differences in its standards only as needed to address issues particular to the audits of public companies in the U.S. In those instances where the PCAOB decides to diverge from the ISAs or ASB standards, the PCAOB should provide a clear and full explanation of the difference, the reason for the difference, and the intended outcome. Providing such information will improve the auditor's understanding of the PCAOB's standards, the auditor's ability to apply the standards, and the transparency of the Board's standard-setting process.

Adoption of an Overall Objectives Standard

One particular overall area of difference between the ISAs and the standards of the PCAOB with which we do not agree, and which we think the PCAOB should address as a high priority, is the absence of an overall objectives standard in the PCAOB standards, similar to ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* ("ISA 200"). Appendix 9 did not articulate the PCAOB's reasons for rejecting this suggestion, which was raised by us and several other commenters[3] in relation to the original proposed standards.

Such a standard would:

- Establish the auditor's overall responsibility when conducting an audit;
- Set out the overall objectives of the auditor;
- Explain the nature and scope of the audit and the inherent limitations of an audit;
- Explain the scope, authority, and structure of the PCAOB standards, including language that denotes requirements;
- Include a discussion of the use of professional judgment;
- Explain how the objectives of each standard relate to the overall framework of PCAOB standards.

While Appendix 1, *Audit Risk* contains some elements of ISA 200, its focus is too narrow, and it excludes certain fundamental principles addressed in ISA 200. We believe it is very important for the Board to explain the fundamental concepts related to the performance of audits and to create guiding principles related to the development of PCAOB standards. Doing so will help clearly communicate the principles of the audit and expectations for auditors. To achieve this, we recommend that the PCAOB immediately commence a project to develop an overall objectives standard, using ISA 200 as a starting point.

D. Standard-setting agenda, timetable, and effective date

Standard-setting agenda and timetable

As noted above, we recognize the initiatives underway by the PCAOB to increase transparency in its standard-setting process. This includes public communication of the PCAOB's standard-setting agenda for 2010. Based on this agenda, it appears that the volume of activity is expected to increase sharply in the short-term. We are not sure whether the PCAOB has contemplated undertaking revisions to its existing standards as part of a broader project such as the IAASB's clarity project completed in 2008 or the ASB's clarity and convergence project expected to be completed later this year. For both these projects, the standard setters undertook a comprehensive activity to revise and redraft their auditing standards within a defined and relatively short time frame. While projects such as these require a significant resource commitment, the improvement in audit quality arising from improved auditing standards is expected to be significant. Completing such a project in a "big bang" approach is useful in that when the standards are revised over a relatively short period, greater internal consistency is achieved and issues of lingering differences in terminology and structure are mitigated. To the extent possible, we recommend that the PCAOB undertake a project to holistically revise and redraft its standards over as short a time period as possible. If the PCAOB agrees to use the ISAs as a starting point (which we highly

[3] See, for example, the comment letters submitted by the U.S. Government Accountability Office, the New York State Society of CPAs, Grant Thornton, and the Center for Audit Quality on the originally proposed PCAOB risk assessment standards, in addition to the comment letter we submitted.

recommend), the PCAOB could leverage the work undertaken by the ASB in its clarity and convergence project in which detailed comparisons of the ISAs to the extant SASs (which are similar to the PCAOB's interim standards) were developed.

We understand that there may be complications in undertaking such a project on an aggressive timetable, and that a slower "conversion" period may be necessary. If that is the case, we recommend that the PCAOB consider "bundling" its standards into smaller groups, linked by commonalities within the group. For example, the reporting standards could be worked on as one group. As another example, the principal auditor/group audits standard and the quality control standards could be another group. Because there are significant interactions between standards, to the extent that those standards that are most interlinked can be revised concurrently the better the likely outcome.

Effective date of the Proposed Standards

We found the inclusion of a proposed effective date for the Proposed Standards to be helpful. However, given the PCAOB's active timetable for standard-setting activities in 2010 and beyond, we encourage the PCAOB to revisit the feasibility of the effective date suggested for the Proposed Standards (i.e., years beginning after December 15, 2010). Given the Proposed Standards cover activities early in the audit engagement, the effective date needs to provide time for engagement teams to apply these requirements at the beginning of the audit cycle, rather than after the audit period has begun.

Since the finalization of the PCAOB's standards is dependent on the SEC's approval process, we recommend that as a general rule the effective date for new or revised standards be tied to that process (e.g., standard will be effective 6 – 12 months after the date the SEC approves the new standard). The length of time might be determined based on a consideration of the effect of the standard(s) and the extent of change expected. We believe this approach would be preferable to an approach of selecting what could very well turn out to be an arbitrary date. In addition, providing auditors with a sufficient period of time between the SEC's approval of the standard and its effective date should enable firms to have sufficient time to update their methodologies, training materials, and systems of quality control to reflect the changes. If firms are not given time to adequately deliberate and address changes arising from revised standards and determine their impact on internal guidance and processes, audit quality may likely be diminished and new or revised standards will not likely achieve their intended outcomes.

II. Specific Comments on Proposed Standards by Paragraph

PCAOB Appendix 1 – Audit Risk in an Audit of Financial Statements

The objective of the auditor, as stated in Appendix 1 is "to conduct the audit of the financial statements in a manner that reduces audit risk to an appropriately low level." While the topics included in this Appendix relate to the overall audit, important concepts, guidance, and principles related to an audit on an overall basis are not included. For instance, a description of reasonable assurance and the inherent limitations of an audit are not included in this Proposed Standard. For these reasons and the reasons articulated in our Overall Comments, we recommend the PCAOB use the material in Appendix 1 and ISA 200 to propose and adopt an overall objectives standard, in lieu of adopting Appendix 1 as proposed.

Paragraph 1: We believe that the wording of paragraph 1 has been revised from the original proposed standard to alleviate concerns raised by commenters that, as originally proposed, the paragraph created the impression that in an integrated audit the auditor performs two separate risk assessments and that the audit of internal control over financial reporting (ICFR) is separate from the audit of the financial statements. However, we still believe that, as written, paragraph 1 and the related footnote implies that there are two separate risk assessments. We believe that there is one risk assessment that is foundational to both aspects of an integrated audit. We believe that paragraph 1 should be amended as follows:

> This standard discusses the auditor's consideration of audit risk and applies to audits of financial statements and integrated audits. When the auditor is performing an integrated audit, the requirements and guidance in Auditing Standard 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, are also applicable; however, the same risk assessment process forms the foundation for planning and performing procedures designed to support the auditor's opinion on the financial statements and internal control over financial reporting.

Paragraph 2: We note a terminology difference between the wording of the objective in paragraph 2 and the wording of the objective of ISA 200. In Appendix 1, the level of audit risk is described as "appropriately low," while in the ISA it is described as "acceptably low." In line with our Overall Comments about terminology and convergence, it is unclear why the difference exists and whether the PCAOB expects a different threshold to be used by the auditor when evaluating audit risk.

In Appendix 9, the PCAOB indicates the rationale behind the difference in wording from the ISA ("appropriately low" aligns with the language proposed by the PCAOB in the last sentence in paragraph 3, which has been added since the original proposed standard), but does not indicate whether a substantive difference is intended.

We note that PCAOB standards, including the Proposed Standards, use both terms

PCAOB Appendix 1 – Audit Risk in an Audit of Financial Statements
interchangeably when describing the evaluation of risks. • For example, paragraph 10 of Appendix 1 states: "For a given level of audit risk, the **acceptable level** of detection risk bears an inverse relationship to the risk of material misstatement at the assertion level. The lower the risk of material misstatement, the greater the detection risk that can be accepted. Conversely, the greater the risk of material misstatement, the less the detection risk that can be accepted. As the **acceptable level** of detection risk decreases, the assurance provided from substantive tests should increase." • For example, paragraph 9 of AU 330, *The Confirmation Process,* states: "The auditor should assess whether the evidence provided by confirmations reduces audit risk for the related assertions to an **acceptably low level.** In making that assessment, the auditor should consider the materiality of the account balance and his or her inherent and control risk assessments. When the auditor concludes that evidence provided by confirmations alone is not sufficient, additional procedures should be performed. For example, to achieve an **appropriately low level** of audit risk related to the completeness and existence assertions for accounts receivable, an auditor may perform sales cutoff tests in addition to confirming accounts receivable." If the terms can be read as synonymous, we believe it would be preferable to use terminology consistent with that in the ISA so as not to cause confusion about whether the PCAOB is creating an intentional difference. If it is the case that the PCAOB is creating an intentional difference, this difference should be fully explained by describing (1) the reason therefore, (2) how the auditor's performance would be different, and (3) the intended outcome. Further, if a difference is intended, the PCAOB should review its existing standards to determine if conforming changes need to be made to other standards.
Paragraphs 9 and 10: We continue to be concerned about the narrowness of the statement that "the level of detection risk is reduced by performing substantive procedures." The movement of this sentence from paragraph 10 in the original proposed standard to paragraph 9 in Appendix 1 does not allay our concern. While we agree with the statement, we believe it may imply that detection risk can **only** be reduced by substantive procedures, and not other procedures such as risk assessment procedures. In Appendix 9, the PCAOB "acknowledges that auditors might obtain evidence of misstatements through procedures other than substantive procedures." However, this acknowledgement is not reflected in the discussion in paragraphs 9 and 10. To avoid unnecessary confusion, we recommend that the second sentence of paragraph 9 be deleted. We also recommend that the last sentence in paragraph 9 and the last sentence in paragraph 10 be broadened to refer to "audit procedures" as opposed to "substantive procedures" or "substantive tests," respectively.

PCAOB Appendix 2 – Audit Planning and Supervision
We believe that the concepts of planning the audit and supervision have been integrated into a single Proposed Standard because these concepts are combined in the PCAOB's existing standards. While we acknowledge that selecting the engagement team is part of the audit planning process, supervising the team occurs throughout the audit. We believe the concepts of audit planning and supervision are separate and distinct, and we therefore believe that they warrant individual attention in two different standards, as they have been treated in the ISAs.
Paragraph 3: As noted in our Overall Comments regarding terminology above, the use of "auditor" and "engagement partner" seem inconsistent. As a further example, paragraph 3 specifies the responsibilities of the "engagement partner" and refers to the definition provided in the Appendix to the Proposed Standard. Paragraph 4 requires the "auditor" to properly plan the audit. It is unclear whether the auditor referred to in paragraph 4 means the engagement partner. We recommend that the PCAOB revisit its use of the terms "auditor" and "engagement partner," particularly in requirements, to clarify to whom the requirements are directed.
Paragraph 6: The Note to paragraph 6 has been modified from the original proposed standard. In the original standard, the wording of the note was factual: Note: The decision regarding continuance of the client relationship and determination of compliance are not limited to preliminary engagement activities and could change with changes in circumstances. In the Proposed Standard, the wording has been revised to contain an auditor requirement to re-evaluate the decisions regarding continuance and compliance with "changes in circumstances." However, no additional guidance has been provided regarding the nature of "changes in circumstances" where it would be appropriate for the auditor to re-evaluate these decisions. We did not see an explanation for the change in Appendix 9 so it is not clear what prompted the PCAOB to convert the note into a requirement. We believe the concept of awareness of continuance and compliance issues being a continuing process throughout the audit is more clearly expressed as written in the original proposed standard (i.e., not stated as a requirement) and therefore recommend the PCAOB use that language. If the PCAOB retains the auditor requirement, in line with our comments on the structure of the standards above, we recommend that requirement be included in the main text of the paragraph rather than in a note and that the PCAOB clarify the rationale for the requirement and its intended meaning.
Paragraph 10b: Proposed Auditing Standard *The Auditor's Responses to the Risks of Material Misstatement* and AS 5 both include requirements to consider an assertion-level audit response. However, paragraph 10b does not specify that the audit plan should include planned tests at the relevant assertion level. In order to be consistent, we recommend

PCAOB Appendix 2 – Audit Planning and Supervision
paragraph 10b be revised to read "…the planned nature, timing and extent of tests of controls and substantive procedures at the relevant assertion level."
Paragraphs 11-14: We refer you to our Overall Comment on the integration of requirements and guidance related to Multi-location Engagements into the Proposed Standards.
Paragraphs 16-18: As noted above, we believe that the requirements related to supervision should be included in a separate standard rather than being coupled with requirements related to audit planning. Whether the PCAOB decides to implement that recommendation or retain the paragraphs in a combined standard, we recommend that the structure of paragraphs 16 – 18 be revised, as we found the paragraphs to be confusing and their content to be somewhat redundant. The Note in paragraph 16 defines "specialized skill or knowledge" as "persons engaged or employed by the auditor who have specialized skill or knowledge." The first sentence of paragraph 17 then reads: "If a person with specialized skill or knowledge *employed or engaged by the auditor* participates in the audit…" We believe that the italicized language is unnecessary and potentially confusing, since the Note in paragraph 16 has already defined "specialized skill or knowledge" as referring to persons engaged or employed by the auditor. We further believe that paragraph 18 and the Note to paragraph 16 are redundant of each other, with paragraph 18 just providing slightly more detailed content. We suggest that the Note to paragraph 16 be deleted. In addition, we recommend that "apply" in paragraph 16 be replaced with "plan and perform" as the auditor should consider whether specialized skill was needed in planning the procedures as well as executing them.
Paragraph 17: As currently stated, the third bullet of paragraph 17 indicates that the auditor should have sufficient knowledge to enable the auditor to evaluate the results of the procedures performed by the person (with specialized skill or knowledge) "as they relate to the nature, timing and extent of other planned audit procedures and the effects on the auditor's report." We believe the desired outcome of the auditor's evaluation would be more clearly stated as follows: Evaluate the adequacy of that person's work including the relevance and reasonableness of that person's findings or conclusions and their consistency with other audit evidence. We believe this more clearly articulates the nature and purpose of the auditor's evaluation of the work of the person with specialized skill or knowledge; namely the auditor would want to evaluate the findings as audit evidence and how that audit evidence "fits" with the other audit

PCAOB Appendix 2 – Audit Planning and Supervision

evidence. We note that our suggested language is consistent with language in ISA 220, paragraph A20.

PCAOB Appendix 3 – Consideration of Materiality in Planning and Performing an Audit

Paragraph 2: Appendix 9 provides the PCAOB's rationale for modifying the discussion of the concept of materiality in terms of the Supreme Court's interpretations of federal securities laws rather than in terms of the applicable accounting framework. As a result of this change, the Proposed Standard uses the perspective of a "reasonable investor" in evaluating materiality rather than a "reasonable person relying on the report." It is not clear whether narrowing the perspective to investors, rather than other persons who may rely on the report, is expected to affect the auditor's determination, or evaluation, of materiality. The PCAOB should communicate whether the change was intended solely to align the PCAOB standards with existing interpretations of federal securities laws or whether a substantive change in practice is expected.

Paragraph 3: As noted in our Overall Comments, we believe that a standard which includes the foundational concepts related to an audit, including a discussion about reasonable assurance and its meaning, should be developed and incorporated into the PCAOB's auditing standards. Having such a standard would facilitate an understanding of reasonable assurance in the context of its placement in paragraph 3 of the Proposed Standard. In addition, we note that paragraph 3 appears to be based on excerpted elements of paragraphs 6 and A1 of ISA 320, *Materiality in Planning and Performing an Audit* ("ISA 320"). We believe that the concepts described in paragraph 3 would be clearer and easier for auditors to apply if the language of the paragraph more closely mirrored that of paragraph 6 of ISA 320, which contains a more complete discussion:

> In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:
>
> 1. Determining the nature, timing and extent of risk assessment procedures;
> 2. Identifying and assessing the risks of material misstatement; and
> 3. Determining the nature, timing and extent of further audit procedures.
>
> The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in the aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size

PCAOB Appendix 3 – Consideration of Materiality in Planning and Performing an Audit
but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.
Paragraphs 8 and 9: The paragraphs use the term "tolerable misstatement" to explain what we believe is the concept of "performance materiality" as used in the related ISA (see ISA 320, paragraph 11) and revised SAS (see revised AU 312, *Materiality in Planning and Performing an Audit*, paragraph 11). Using the term "tolerable misstatement" to describe what is defined as "performance materiality" in the ISAs will cause confusion. Appendix 9 indicates that the PCAOB believes use of "tolerable misstatement" will be less confusing than using "performance materiality" because it is the term currently used, and because non-auditors may be confused because "performance materiality" contains the word "materiality." On the first point, we believe that adoption of "performance materiality" will relieve existing confusion in practice, rather than create it, for the reasons stated below. The term "tolerable misstatement" in the ISAs is the ***application*** of performance materiality to a particular sampling procedure, and may be the same amount or an amount lower than performance materiality. "Performance materiality," however, is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an acceptably low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. As part of its clarity project to revise ISA 320, the IAASB addressed the confusion that existed in practice at that time about the dual use of the term (as both the amount set at less than materiality for the financial statements as a whole and the application of that amount to a sampling procedure) by using two terms: performance materiality and tolerable misstatement. We believe the PCAOB should adopt the same approach as the IAASB in order to mitigate the existing confusion in practice and to prevent future confusion about the difference in terminology between the standards of the IAASB and ASB and the standards of the PCAOB. If the PCAOB chooses to retain the term "tolerable misstatement" to cover both concepts, Appendix 10 comparing the PCAOB's standards with the ISAs and SASs will have to point out that "tolerable misstatement" in the PCAOB standards can mean either "tolerable misstatement" or "performance materiality" in the ISAs. On the second point about the potential confusion of non-auditors, we believe the use of the term "performance materiality" (particularly given its use of the related word "materiality") would actually assist the non-auditor in understanding the relationship between materiality for the financial statements as a whole and the implementation of that concept in planning and performing the audit.
Paragraph 10: We refer you to our Overall Comments on the integration of requirements and guidance related to Multi-location Engagements into the suite of re-proposed Risk Assessment standards.

PCAOB Appendix 3 – Consideration of Materiality in Planning and Performing an Audit
In addition to our Overall Comments, we believe that the requirement in paragraph 10 does not contemplate a situation where the principal auditor refers to the work of another auditor in the audit report on the group financial statements in accordance with AU 543, *Part of Audit Performed by Other Independent Auditors*. In such situations, the principal auditor may not influence, or even be aware of, the materiality level used by the auditor to whom the principal auditor will refer. It is unclear what the principal auditor should do in those situations in addressing the requirement in paragraph 10.
Paragraph 11: The auditor action required by the paragraph ("the auditor should reassess" the materiality level) is different than the analogous paragraph in ISA 320 ("the auditor shall revise materiality"). The wording of paragraph 11 (i.e., to reassess materiality when there is "substantial likelihood that misstatements of amounts that differ significantly from the materiality level or levels that were established initially would influence the judgment of a reasonable investor") is also rather convoluted and may be more difficult to understand than a more directly worded requirement to revise materiality when subsequent events or information are such that the auditor would have determined a different materiality had the auditor known about them. We are not sure if the PCAOB intends a difference in auditor performance by using different wording in the requirement. If a difference is not intended, we recommend that ISA 320, paragraph 12 (included below), which we believe contains a clearer and more strongly worded requirement, replace paragraph 11 in the Proposed Standard: > The auditor [should] revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. In addition, as currently drafted, there does not seem to be a clear difference between the situations described in paragraphs11a and 11b. Both refer to situations where the amounts used to determine the materiality level or levels have changed, and neither explicitly addresses the point in the audit when the auditor may determine a revision in materiality is warranted. Appendix 9 (page 9-21) includes two detailed examples of situations which may be useful to include in the Proposed Standard. Alternatively, the language in paragraph A13 of ISA 320, which we believe more clearly articulates the concepts related to the revision of materiality as the audit progresses, could be used.

PCAOB Appendix 4 – Identifying and Assessing Risks of Material Misstatement

Paragraphs 1, 3, and A4: We note that the objective in paragraph 3 has been revised based on comments received by the PCAOB. It now provides a stronger link between identifying and assessing risks and responding to those risks. We believe the change clarifies the relationship between risk assessments and responses. In addition, the change has resulted in the objective of the Proposed Standard becoming closer to the wording of the objective in ISA 315.

In the same vein, we believe that an additional change to the objective would be useful to clarify *how* the auditor goes about identifying and assessing risks (i.e., based on the auditor's understanding of the company and its environment, including its internal control). We recommend the objective be worded as follows, which would align it with the ISA 315 wording exactly. Appendix 10 did not include the difference in the objective between the two standards, so we presume that no fundamental change in the objective is intended by the PCAOB; therefore, using the ISA 315 wording would seem to be appropriate and would avoid unnecessary confusion:

> The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the [company's] internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

For the same reasons described above (i.e., to make the language in the standard clearer about how the auditor identifies and assesses risks), which we believe will increase the auditor's understanding about how to implement the required auditor action, we recommend the following changes to paragraphs 1 and A4:

Paragraph 1: We believe it would be helpful to add "through understanding the company and its environment, including the company's internal control" at the end of the paragraph.

Paragraph A4: We believe it would be helpful to add "whether due to fraud or error, at the financial statement and assertion levels" to the end of the definition.

Paragraphs 7-13: As noted in our Overall Comments, we are concerned about the use of present tense in the Proposed Standards, because it is unclear whether the PCAOB intends for "provisions" written in present tense to be considered requirements. Paragraphs 7 – 13 provide a cluster of examples of the lack of clarity caused by the use of present tense. For example:

- Paragraph 7 has a requirement for the auditor to obtain an understanding of the company and its environment. That requirement is followed by a statement that "obtaining an understanding of the company includes understanding the following:"
- Paragraph 10 indicates that "obtaining an understanding of the nature of the

PCAOB Appendix 4 – Identifying and Assessing Risks of Material Misstatement
company includes understanding the following:" o Paragraph 12 states that "The following matters, if present, are relevant to the necessary understanding…" Based on our understanding of Rule 3101, we do not believe that present tense statements obligate the auditor to perform the activity described by the present tense. We believe in the paragraphs cited above, the lists following the paragraphs may not be relevant in all situations and therefore it would not be appropriate to require the auditor to pursue each item on the list. Accordingly, it would be appropriate for the auditor to use the lists as guidance in applying the requirements that are identified in accordance with Rule 3101.
Paragraph 10: The first Note in paragraph 10 indicates that "the size and complexity of a company might affect the risks of misstatement and how the company addresses those risks." We believe all of the bullets in paragraph 10 may affect the risks of misstatement, and the company's responses thereto (e.g., the sources of funding of the company's operations, the company's organizational structure). It is unclear why size and complexity are singled out for emphasis, and we therefore recommend that the Note in paragraph 10 be deleted. As noted in our Overall Comments, the purpose and use of Notes by the PCAOB is unclear. As a result, we believe that requirements should not be placed in Notes. The second Note in paragraph 10 includes a requirement for the auditor to "take into account" the information gathered when obtaining an understanding of the company in order to determine the existence of related parties. The action to "take into account" is sufficiently unclear in this context as to make it difficult for the auditor to demonstrate and document compliance with the requirement. Furthermore, we believe the principle embodied in the Note is factual (as it is structured in paragraph A23 of ISA 315) and should be stated as such in the Proposed Standard in place of the requirement: An understanding of the nature of a [company] enables the auditor to understand such matters as: The ownership and relations between owners and other people or [companies]. This understanding assists in determining whether related party transactions have been identified and accounted for appropriately.
Paragraph 11: We believe that the second bullet in paragraph 11 is extremely broad, and that a requirement for the auditor to consider "observing or reading transcripts of earning calls and, to the extent publicly available, other meetings with investors or rating agencies" will be onerous and likely ineffective. Obligating the auditor to determine the existence and timing of all "other meetings with investors" in order to consider attending them and to document why or why not the auditor attended such meetings would likely be very onerous and would result in additional costs without an equal benefit. We therefore recommend that this bullet be deleted from the list in paragraph 11.

PCAOB Appendix 4 – Identifying and Assessing Risks of Material Misstatement
Paragraphs 20 and 62 - 65: Paragraphs 64-65 imply that walkthroughs would be sufficient for evaluating whether a control has been implemented. The first Note in paragraph 20 states that a walkthrough is ordinarily sufficient to evaluate design effectiveness, but neither the first nor second note make it clear that a walkthrough is ordinarily sufficient to evaluate implementation. In order to be consistent with paragraphs 64 – 65 and to clarify paragraph 20, we recommend such a statement be added to the second Note to paragraph 20.
Paragraph 24: The wording of this paragraph provides an additional example of our Overall Comments related to the use of present tense, and the confusion it causes as to whether the PCAOB intends a required auditor action. We note that in the original proposed standard the paragraph was worded as a requirement ("should assess"). We believe paragraphs 23 and 24 would be more understandable to the auditor if they were combined, with the header to the bullet list reading as follows: The auditor should obtain an understanding of the company's control environment, including the policies and actions of management, the board and the audit committee concerning the company's environment, including:
Paragraph 39: We are concerned about the language of the requirement for the auditor to "*incorporate* knowledge obtained during past audits into the auditor's process for identifying risks of material misstatement…" This is not an actionable instruction as it is not clear what "incorporate" means or how the auditor would demonstrate compliance with this requirement. Further, it is not clear whether the requirement would be met if the auditor determined not to use prior-year work, for example, because changes to the control environment have affected the relevance of the information. We believe the wording of the analogous paragraph in ISA 315, paragraph 9 is clearer, and recommend that it replace paragraph 39: When the auditor intends to use information obtained from the auditor's previous experience with the [company] and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit.
Paragraph 42: As noted in our Overall Comments, there seems to be some confusion about the use of, and relationship between, "auditor" and "engagement partner" in the Proposed Standards. It is unclear from paragraph 42, whether "auditor" refers to the engagement partner, the registered public accounting firm, or a network of related firms if one exists. The more broadly the term is incorporated into a requirement such as this one, the more of a practical challenge it will likely pose, and therefore care needs to be taken such that the incremental effort is really intended and appropriate. Similarly, without any guidance, the interpretation of "other information" could be quite broad. In a multi-location, multi-national audit engagement, the gathering of that "other information" from all individual auditors

PCAOB Appendix 4 – Identifying and Assessing Risks of Material Misstatement
participating on other engagements for the purposes of the group audit would likely consume significant resources and drive costs that would not seem to achieve commensurate benefit. We recommend that the language of ISA 315, paragraph 8 be used in place of paragraph 42, as we believe it more clearly reflects an appropriate auditor action: If the engagement partner has performed other engagements for the [company], the engagement partner [should] consider whether information obtained is relevant to identifying risks of material misstatement.
Paragraphs 43 and 45: The note in paragraph 45 indicates that analytical procedures performed as risk assessment procedures are "ordinarily not designed with the level of precision necessary for substantive analytical procedures." However, the language in paragraphs 43 and 45 seems to be describing substantive analytical procedures as opposed to preliminary analytical procedures. Paragraph 45 discusses developing expectations and comparing those expectations with recorded amounts, which implies an extent of procedures more common to substantive analytical procedures and apparently different from the PCAOB's existing guidance on preliminary analytical procedures, included in paragraphs 6 – 8 of AU 329, *Analytical Procedures*. It is unclear whether the PCAOB intends a change in practice regarding the execution of analytical procedures performed as risk assessment procedures.
Paragraph 67: This paragraph states that "the auditor should not assume that all of the conditions discussed in paragraph 66 must be observed or evident to conclude that a fraud risk exists." It is not clear what action the auditor would need to take to "not assume" and then how the auditor would document that negative assumption.
Paragraph B6: The requirement in this paragraph to "design procedures to test the consistency in the application of manual controls" when a company uses manual elements in internal control systems is misleading and out of context. It may imply that for any manual controls, the auditor is required to perform testing. We believe the paragraph should read: When a company uses manual elements in internal control systems and the auditor is planning to rely on, and will therefore test, those manual controls, the auditor should design procedures to test the consistency in the application of manual controls.

PCAOB Appendix 5 – The Auditor's Response to the Risks of Material Misstatement
Paragraphs 1 and 2: In the objective of Appendix 4, *Identifying and Assessing Risks of Material Misstatement*, we note that the PCAOB has improved the linkage between identifying and assessing risks of material misstatement, and then implementing responses to those risks, by adding language to the objective since the original proposed standard. To be consistent, we recommend the PCAOB similarly strengthen the linkage in the objective of this Proposed Standard to the identified risks. We believe the objective should read as follows: The objective of the auditor is to address the identified risks of material misstatement through appropriate overall audit responses and audit procedures. In Appendix 9, the PCAOB indicates that it received similar comments on the objective in the original proposed standard. We also note the PCAOB has included a mandatory requirement in paragraph 3 of the revised Proposed Standard to design and implement responses that address the risks identified and assessed in the Proposed Standard, *Identifying and Assessing Risks of Material Misstatement*, as a means of making the linkage outside of the objective. However, we continue to believe that the objective would be more appropriate worded as we suggest above. Further, for the reasons stated above and to have consistency between paragraphs 1 and 2, we believe paragraph 1 should read as follows: This standard establishes requirements and provides direction regarding designing and implementing appropriate responses to the identified risks of material misstatement.
Paragraphs 11 and 13: These paragraphs create presumptively mandatory requirements to perform substantive procedures, including tests of details, in response to assessed significant risks and assessed fraud risks, respectively. Appendix 9 states that “existing PCAOB standards indicate that tests of details should be performed in response to significant risks” and it references AU 329, paragraph 9. That paragraph states: The auditor’s reliance on substantive tests to achieve an audit objective related to a particular assertion may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedure or procedures to use to achieve a particular audit objective is based on the auditor’s judgment on the expected effectiveness and efficiency of the available procedures. For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient. We do not believe, as written, that paragraph 9 of AU 329 and the proposed language in paragraphs 11 and 13 are equivalent. Our interpretation of the last sentence of AU 329 paragraph 9 is that it would be acceptable for an auditor to perform tests of relevant controls in combination with substantive analytical procedures to address a significant risk (including a fraud risk), i.e., in such a case the auditor’s evidence is not being derived from substantive analytical procedures alone. Our interpretation of paragraphs 11 and 13 is that this approach would no longer be acceptable and that substantive tests of details would now be required in addition to, or in place of, substantive analytical procedures. This would be a significant change in practice and one that

PCAOB Appendix 5 – The Auditor's Response to the Risks of Material Misstatement
we believe will likely increase cost without necessarily resulting in a more effective audit. We continue to believe that the auditor, based on judgment, the risks identified, and the facts and circumstances of the situation, should be able to decide whether to perform substantive analytical procedures or test of details in response to any identified risk and should not be limited to the types of procedures to perform. We do, however, continue to believe that evidence from substantive analytical procedures alone (i.e., without also performing tests of relevant controls) is unlikely to be sufficient and appropriate in addressing significant risks of misstatement.
Paragraph 29: Paragraph 29 requires the auditor when testing operating effectiveness as of or through an interim date to "determine what additional evidence concerning the operation of the controls for the remaining period is necessary" but it does not require the auditor to also "obtain audit evidence about significant changes to those controls subsequent to the interim period" as ISA 330 paragraph 12 does. We are concerned that the PCAOB requirement could be perceived as weaker than the ISA, and therefore recommend that bullet (b) of ISA 330, paragraph 12 be added to paragraph 29.
Paragraph 31: The paragraph does not provide the perspective that over time as the audit evidence ages, the less relevant it will become. We believe that paragraphs 13 and 14 of ISA 330 provide useful considerations about the relevance of audit evidence (1) over the passage of time and (2) over the period of time that elapses between testing of a control and retesting the control. We recommend that the PCAOB consider incorporating these paragraphs into the Proposed Standard, particularly the requirement in paragraph 14 to test controls at least once every third audit if no significant changes in controls have occurred.

PCAOB Appendix 6 – Evaluating Audit Results
Paragraph A2: We believe the definition of "misstatement" is unclear because (1) it includes the term "misstatement" within the definition and (2) appears to be defining a misstatement as being only a material misstatement (i.e., an immaterial error would not be considered a misstatement). As noted in our Overall Comments related to terminology, as well as convergence, we feel this is one area where a difference with the ISA definition of "misstatement" is unwarranted, and may cause unnecessary confusion. We do not believe the PCAOB intends for there to be a difference in meaning. In Appendix 9, the PCAOB references guidance in AU 312, *Audit Risk and Materiality in Conducting an Audit* and AU 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312* as rationale for retaining the proposed language. While we recognize the PCAOB may have an aversion to changing terminology related to misstatements,

PCAOB Appendix 6 – Evaluating Audit Results
we also note that it has not chosen to carry forward the terminology "known" and "likely" misstatements, which is also currently used in AU 312. We therefore suggest that the PCAOB use the definition of "misstatement" in ISA 450, *Evaluation of Misstatements Identified During the Audit*: A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the items to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.
Paragraph 12: The types of misstatements that the auditor accumulates are detailed in paragraph 12 of the Proposed Standard, but it does not use the same categorization, or "buckets" as are used by the ISAs: factual misstatements, judgmental misstatements, and projected misstatements. Nor does it use the same categorization as AU 312, as noted above. We believe being able to clearly distinguish the types of misstatements assists the auditor in accumulating and evaluating them. Such categorization also makes it easier for management and audit committees to understand misstatements and also to correct them. It is unclear why such helpful guidance would not be included in the PCAOB's standard.
Paragraph 15: In the Proposed Standard, the auditor is required to communicate accumulated misstatements to management, but there is no requirement for the auditor to request management to correct misstatements. This differs from the PCAOB's existing requirement in AU 312 for the auditor to request management to "eliminate" likely misstatements that, individually or in the aggregate, cause the financial statements to be materially misstated. We believe that an auditor requirement to request management to correct all misstatements accumulated during the audit, other than those that are clearly trivial, is appropriate. Appendix 9 indicates that such a requirement is unnecessary because "management has its own legal responsibilities in relation to the preparation and maintenance of the company's books, records, and financial statements." However, a requirement in the Proposed Standard would be for the auditor, not management, and would provide an important link between the auditor requesting management to correct and management's subsequent actions in that regard. Management's failure to correct misstatements that the auditor has requested be corrected may also be relevant information to the auditor and the auditor's risk assessment.
Paragraphs 18: We recommend that additional context be provided to paragraph 18 by including a reference to SEC Staff Accounting Bulletin 108, codified as SAB Topic 1.N, "Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements." We believe this will be especially useful for auditors outside the U.S. jurisdiction who are applying the standards of the PCAOB.

PCAOB Appendix 6 – Evaluating Audit Results

Paragraph 20: The second sentence of the paragraph contains an excerpt of paragraph .05 of AU 316 defining "fraud." However, in not including the paragraph in its entirety, the paragraph does not convey the full context of paragraph .05. In addition, while fraud risk is discussed earlier in the Proposed Standard (paragraph 4d) and the term "fraud" is used earlier in the Proposed Standard, it is unclear why the second sentence is placed in paragraph 20 of the Proposed Standard rather than in an earlier paragraph.

Paragraph 27: The second sentence of the paragraph discusses management bias, but only in a "one-way" direction (i.e., increases in income). We believe it would be relevant to discuss both directions of potential bias (i.e., as efforts to improve or worsen reported results). Alternatively, if the second sentence is meant to be an example, it should be labeled as such.

Paragraph 31: The second sentence of paragraph 31 causes us two concerns:

1. It is written in the present tense, and given its placement is difficult to determine whether the PCAOB believes it is a requirement
2. The level of detail provided for consideration in evaluating disclosures (e.g., form, arrangement, content, terminology, and classification) may be difficult to implement and assess, given the relevant authoritative accounting framework and related literature may not be that detailed.

We agree with the addition of guidance related to evaluating disclosures, but recommend that the PCAOB clarify that the auditor's evaluation of disclosures is performed within the context of the requirements of the applicable accounting framework.

Paragraph 35: We believe the use of "substantial doubt" in the context of evaluating audit results may be confusing in light of its more frequent use in the context of the going concern evaluation. As noted in our Overall Comments related to terminology, this is an example where a review of terms used in the Proposed Standards could assist in "cleaning up" terminology. While we recognize the term is used in AU 326, *Evidential Matter*, we recommend that the PCAOB eliminate the phrase in the Proposed Standard which includes "substantial doubt" as we believe the point of the paragraph is covered sufficiently within the context of sufficient appropriate audit evidence. Therefore, we recommend that the first sentence of paragraph 35 read as follows:

> If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion, the auditor should attempt to obtain further audit evidence to address the matter.

PCAOB Appendix 7 – Audit Evidence
Paragraphs 3 - 4: We are unsure why there is a difference between the language used in the objective (i.e., "plan and perform") and the requirement in paragraph 4 (i.e., "design and perform"). We believe the language used should be consistent between the two paragraphs.
Paragraph 11: We strongly recommend that the PCAOB consider using the assertions as described in the ISAs, as well as in the ASB's standards. The assertions used by these standard setters do not differ greatly overall from the assertions included in the Proposed Standards. However, on an individual basis, the assertions are more granular and we believe will be more helpful to auditors in both assessing risks of misstatement and planning and performing procedures to address those risks. For example, the ISA assertions about presentation and disclosure include classification and understandability: that financial information is appropriately presented and described and disclosures are clearly expressed. We believe that this level of detail would be very helpful in improving audit quality and in addressing certain shortcomings noted in the PCAOB's *Report on First-Year Implementation of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (September 24, 2009).
Paragraph 18: Appendix 9 does not explain why paragraph 18 was changed to eliminate the guidance about written confirmations. The phrase, "written confirmations might be received in paper form, or by electronic or other medium" implied an expectation that confirmations would be in writing. We believe confirmations should be obtained by the auditor as a direct written response to the auditor from a third party, and therefore suggest the reinstatement of this guidance, or something similar in the Proposed Standards.

PCAOB Appendix 8 – Conforming Amendments
General Comment: While we agree with replacing "competent" with "appropriate" throughout the standards, this change results in the phrase "sufficient appropriate evidential matter." The entire phrase therefore needs to be replaced with "sufficient appropriate audit evidence" to be consistent with the title of Appendix 7 and language used in the Proposed Standards. **AU 322:** Based on the proposed Conforming Amendments, footnote 3 to paragraph 4 contains a reference to Proposed Standard, *Identifying and Assessing Risks of Material Misstatement* (Appendix 4); and states that the Proposed Standard "indicates that the internal audit function is part of the entity's control environment." However, there is no discussion of internal audit as being part of the entity's control environment in paragraphs 23 – 25 of Appendix 4; rather,

internal audit is discussed in the context of monitoring in paragraph 34 of this Proposed Standard. We suggest the footnote be modified accordingly.

Additionally, the proposed Conforming Amendments for AU 322 include a reference to paragraph 42 of Proposed Standard, *The Auditor's Responses to the Risks of Material Misstatements*, in Footnote 5. We do not understand why the footnote reference is to paragraph 42, which discusses the extent of substantive procedures.

AU 329: While paragraph .03 was deleted (see text below), this paragraph still appears to be relevant to substantive analytical reviews; therefore, we recommend retaining this paragraph.

> Understanding financial relationships is essential in planning and evaluating the results of analytical procedures, and generally requires knowledge of the client and the industry or industries in which the client operates. An understanding of the purposes of analytical procedures and the limitations of those procedures is also important. Accordingly, the identification of the relationships and types of data used, as well as conclusions reached when recorded amounts are compared to expectations, requires judgment by the auditor.

AU 350: In paragraph .09 of AU 350, we recommend the reference should be to paragraphs 3 through 10 of Proposed Standard, *Audit Risk*, as opposed to paragraphs 5 through 10.

ET 102: The reference in footnote 1 to paragraph .05 has been revised to refer to the Proposed Standard, *Audit Planning and Supervision*. However, the discussion regarding disagreements was removed from the Proposed Standard and has now been proposed as a conforming amendment to AS 3. If the conforming amendment is made to AS 3, this reference should be changed accordingly.

ERNST & YOUNG

Ernst & Young LLP
5 Times Square
New York, NY 10036

Tel: 212 773 3000
www.ey.com

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

1 March 2010

Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Related Amendments to PCAOB Standards, PCAOB Rulemaking Docket Matter No. 026

Dear Office of the Secretary:

Ernst & Young LLP (Ernst & Young) is pleased to submit this comment letter to the Public Company Accounting Oversight Board (PCAOB or the Board) in response to the PCAOB's request for comment regarding the reproposed auditing standards related to the auditor's assessment of and response to risk (the reproposed standards).

We support the PCAOB's objective to update its existing interim standards to reflect improvements that firms have made in risk-based audit methodologies and improvements in standards by other standard setters, and believe the reproposed standards will help to improve the framework established by existing PCAOB standards. We concur with the reproposed standards concept that risk assessment, appropriately applied, should underlie the entire audit process, and result in audit procedures that limit audit risk to an appropriately low level.

We commend the Board for the refinements and improvements made to the original proposed standards. We believe that the reproposed standards more appropriately define the requirements for the auditor's assessment of, and response to, risk, and address many of the comments made by us and others on the original proposed standards. However, recognizing that these reproposed standards will serve as the foundation for future standards setting by the PCAOB, we believe that additional modifications would provide further enhancement and clarification of the reproposed standards. We offer a number of overall comments below related to the reproposed standards, particularly related to the improved transparency of the PCAOB standard setting process and the relationship of the reproposed standards to other standard-setters, the importance of convergence in the risk assessment standard area, making the reproposed standards more useable for auditors, amending PCAOB Auditing Standard No. 5, and maintaining a stand-alone fraud standard. We also provide more detail comments on each of the individual reproposed standards in the attachment to this letter.

We would be pleased to discuss any of our comments with members of the PCAOB or its staff.

Sincerely,

Ernst + Young LLP

Attachment

Overall Comments Related to the Reproposed Standards

Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards

We fully support the Board's encouragement for improved transparency in its standard-setting process. We agree with Chairman Daniel L. Goelzer's recommendation on 17 December 2009 urging the Board "to continue to explore ways of making its standards-setting – and the thinking that underlies its proposals – more open." We appreciate the Board's second comment period on these reproposed standards and support the discussion of additional revisions to the reproposed standards with the Board's Standing Advisory Group (SAG) before they are finalized as a step in further improving transparency.

We also encourage the PCAOB to participate in joint meetings of the standards setters and work collaboratively with the International Auditing and Assurance Standards Board (IAASB) and the AICPA Auditing Standards Board (ASB) in the development of future standards. This could be accomplished, for example, by having Board members, or staff, participate in joint task forces with the IAASB and the ASB. We believe that such participation would complement the role of the SAG and other forums that currently inform the Board's agenda and standards-setting activities.

The PCAOB's efforts to increase the transparency of its standard setting process, and an increase in ongoing involvement with other standards-setting bodies, would further enhance the effectiveness of all standards-setters; improve the consistency and understanding of auditing standards around the world; eliminate unnecessary differences among the standards; and clarify the rationale for and understanding of the effect of appropriate differences that remain, such as those necessitated by an integrated audit or by legal or regulatory reasons.

Importance of Convergence in the Risk Assessment Audit Standard Area

We acknowledge the Board's efforts to further align with and reduce differences between the PCAOB standards and the corresponding risk assessment standards of the IAASB and the ASB. The comparison in Appendix 10, which outlines the significant differences in requirements between the Board's reproposed standards and those of the corresponding ISAs and SASs, is helpful in understanding and articulating the differences in requirements among the (existing or proposed) standards. However, we are still troubled by the volume and scope of the remaining differences. For example, signaling that a difference exists (between the Board's proposed standards and those of the ASB) in something as fundamental as the *definition of materiality* leads us to wonder whether such direction will enhance overall audit quality in this country and elsewhere. We believe more progress needs to be achieved in reducing the 50 areas of differences (covering 34 pages) outlined in Appendix 10. We understand that some differences will have to exist, but would hope they could be limited to areas that are unique to the audits of issuers. We recommend that the Board work with the IAASB and the ASB and attempt to reduce the remaining differences prior to the standards being issued in final form.

Some of our comments in the attachment to this letter identify additional areas where we believe greater convergence can still be achieved, without jeopardizing the Board's objective to issue standards appropriate for audits of issuers and that are consistent with the Board's statutory mandate to oversee the audit of public companies subject to the securities laws and to protect the interests of investors.

PCAOB Standards Setting Process

The reproposed standards demonstrate the Board's efforts to respond to comments made on the original proposed standards and the continued consideration of other standards-setters as evidenced by the improvements made in the reproposed standards. We are particularly pleased with the Board's responsiveness to the comments related to the alignment of the proposed standards with PCAOB Auditing Standard No. 5 (AS 5), and other changes to the overall structure of the standards, including adding definitions in an appendix section, as well as the clarifications made to several of the standards' objectives.

We appreciate the insights provided by the Board in the opening release to the reproposed standards, and in Appendix 9, as they have been helpful in interpreting the guidance within the reproposed standards. The Board's views on the comments received and the basis for determining the enhancements and revisions made to the standards as part of the reproposal process were beneficial and provided for a deeper understanding of the rationale of the Board when drafting these standards. However, given that the release is not ultimately part of the final standard, any interpretive guidance contained within it may not be given the same consideration by auditors. This could result in application by auditors that is inconsistent with the Board's intentions.

For example, the additional clarification and interpretation of the standards that is included only in Appendix 9, such as the discussion of the term "taken into account" as discussed further below would be beneficial for auditors if included within the reproposed standards.

We recommend the Board carefully consider the information provided in Appendix 9 and modify the reproposed standards as necessary so that the requirements are able to be interpreted consistently with the Board's intentions.

In addition, as stated previously, although the differences between the reproposed standards and those of the ISAs and SASs included in Appendix 10 are intended to be helpful to auditors in understanding the intent of the Board, we believe that providing such a high level view of the differences may result in confusion for the auditor and ultimately reduce audit quality. We believe that it is important for the Board to consider providing additional insight into how auditor performance is expected to change as a result of proposed standards. Highlighting the expected changes will assist auditors in better understanding and implementing the requirements. Providing additional comparisons and analyses will allow practitioners to have additional visibility into the Board's thought process in developing the PCAOB standards, and enhance auditors' understanding, implementation, and consistent execution of the standards on all audits they perform.

We therefore recommend that the Board consider, for future proposed standards, providing the following:

- specific examples of the expected changes to practice,
- more detailed comparisons to other standard-setters for the public for review, such as matrices comparing individual paragraphs to the ISAs and the SASs,

- a discussion by the Board highlighting areas where the Board does not believe significant differences will exist even though there may be differences in the terminology used in the proposed standards compared to the terminology used by other standards setters, and

- a summary outlining the changes from the Board's extant standards as a result of the proposed standards.

We believe that providing these additional items during a proposal process will help improve audit quality by reducing the confusion when trying to understand the intended changes to current practice and assist auditors in meeting the performance expectations of the Board.

Making the Standards More Usable for Auditors to Improve Audit Quality

We acknowledge the Board's efforts to enhance and improve the risk assessment framework through these reproposed standards. This framework is designed to focus the auditor's attention on appropriate risk identification and developing audit responses tailored to those risks.

Recognizing that these seven reproposed standards, once finalized, will serve as the "bedrock for much of the Board's future standards-setting" as stated by PCAOB Acting Chairman Daniel L. Goelzer in his opening remarks on 17 December 2009, we believe it is an appropriate time for the Board to consider codifying these reproposed standards with the existing PCAOB standards so that the structure of the PCAOB auditing standards become more understandable and usable for auditors to follow. Without such codification, the adoption of these reproposed standards will introduce a third style of standards that is inconsistent with the PCAOB's other standards, as well as numerous conforming amendments, without a clear vision for integrating the standards in the future.

We recommend the Board consider reviewing all of the PCAOB auditing standards and redraft, as necessary, proposed and existing standards in a consistent manner, with the intent of promoting greater understanding and making the standards more usable for auditors, which in turn will further the Board's objective of improving audit quality.

We offer the following comments, as well as the additional comments in the attachment to this letter, for the PCAOB to consider.

Establishment of Clearly Defined Objectives

We support the Board's use of objectives in the reproposed standards, and acknowledge the Board's efforts in revising the objectives of the reproposed standards so that the objectives have a clear statement of purpose. However, as noted in our previous comment letter, we continue to believe that the Board should consider, from the outset, how objectives are intended to fit into the overall framework of PCAOB standards going forward.

We recommend that the Board consider a standard setting project to redraft existing PCAOB standards and draft future standards in a similar structure as the reproposed standards. We recommend as part of this project that the Board consider establishing an overall objective in each PCAOB standard that is clearly defined. The Board's establishment of clearly defined objectives will assist in the auditor's understanding of how the various aspects of the audit fit into the overall framework of the PCAOB standards.

Clarification of Terms Used in the PCAOB Standards

The Board's Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards* (Rule 3101), provides guidance to the auditor related to the requirements for certain terminology used in the PCAOB standards such as "should," "must," and "may". Rule 3101 states that the word "should" indicates responsibilities that are presumptively mandatory. Rule 3101 also explains that, if a Board standard provides that the auditor "should consider" an action or procedure, then consideration of the action or procedure is presumptively mandatory while the action or procedure is not. Rule 3101 does not however discuss or provide direction relative to the various other uses of the word "should," such as "should evaluate," "should include," "should take into account," and "should assess" that are used throughout the reproposed standards. The Board provides clarification in Appendix 9 of the release to the reproposed standards when the phrase "take into account" is used, stating that this phrase is "in reference to information or matters that the auditor should think about or give attention to in performing an audit procedure or reaching a conclusion. Accordingly, the results of the auditor's thinking on the relevant matters should be reflected in the performance and documentation of the respective audit procedures performed or conclusion reached."

We recommend the Board include clarifications similar to the one described above for other derivations of the presumptively mandatory "should" that are not currently included in Rule 3101. We believe these clarifications will allow auditors to better understand the PCAOB expectations, and the specific activities to be performed, thereby improving consistency of performance and quality of audits.

Requirements within Notes and Appendices

While we do not disagree with the Board's use of Notes and Appendices within the reproposed standards to help provide clarification to the guidance within the standards, we do not believe the PCAOB should embed auditor requirements within them. Including requirements in Notes and Appendices makes it more difficult for the auditor to reference back to a requirement and to determine that all requirements are met in the performance of an audit. We recommend that the Board consider "elevating" Notes and Appendices that have embedded mandatory and presumptively mandatory requirements as additional paragraphs within the reproposed standards. We believe this improvement will be beneficial to auditors when applying the guidance within these standards and will help improve overall audit quality by improving the usability of the standards.

We offer additional comments in the attachment to this letter where we have identified instances of requirements in Notes and Appendices for the Board to consider when considering this comment.

Conforming Changes to Auditing Standard No. 5

We commend the Board for their efforts in revising the reproposed standards to better align with AS 5 and recognize that the risk assessment process is basically the same, regardless of whether the audit is of financial statements only or for an audit of internal control over financial reporting that is integrated with an audit of the financial statements (an integrated audit). The reproposed standards, as revised, more clearly articulate the auditor's responsibility in the risk assessment process, whether the audit is of the financial statements only or an integrated audit. We believe, however, that AS 5 should be amended to remove the aspects of the auditor's risk assessment that relate to a financial statement audit. We believe the auditor should look to the reproposed standards when performing a risk assessment for a financial statement audit(whether as a standalone audit or as part of an integrated audit) and should refer to AS 5 only for the additional risk assessment requirements that are necessary in order to perform an audit of internal control over financial reporting. While not consistently applied throughout the reproposed standards, the note to paragraph 12 of the reproposed standard, *The Auditor's Responses to the Risks of Material Misstatement,* provides a good example of such a framework when it refers the auditor to AS 5 for requirements the auditor is to follow when addressing assessed fraud risks in the audit of internal control over financial reporting. We recommend that the Board adopt this type of framework throughout the reproposed standards (i.e., referring the auditor to AS 5 for additional requirements that are necessary for audits of internal control), such that AS 5 would only contain these additional requirements.

We recommend that the Board amend AS 5 to remove content that is duplicative of guidance that is included in the reproposed standards. The risk assessment procedures that relate to financial statement audits, whether or not performed as part of an integrated audit, are contained within the reproposed standards and repeating that same guidance within AS5 is confusing for the auditor. By amending AS 5 to eliminate these duplicative risk assessment procedures, the auditor will more easily be able to determine the additional requirements necessary to execute an audit of internal control over financial reporting in connection with an audit of the financial statements. We further believe this will allow for improvement in the execution of audits of internal control over financial reporting.

Stand Alone Fraud Standard

We agree with the Board that the auditor's responsibility for identifying and responding to risk of material misstatement due to fraud ("fraud risks") is an integral part of an audit and should not be a separate consideration. However, we continue to believe that there is benefit to auditors having a single standard that explains the auditor's responsibilities related to fraud. Extant AU 316, *Consideration of Fraud in a Financial Statement Audit* (AU 316), provides an effective framework for gathering information and using that information to better understand, identify and respond to fraud risks. It describes the responsibilities of the auditor throughout all phases of the audit, beginning with understanding fraud and its characteristics and ending with documenting the auditor's consideration of fraud.

We remain concerned that, after reflecting the reproposed conforming amendments, there will no longer be a single place in the auditing standards that presents a complete picture of the auditor's responsibilities related to fraud. We also are concerned about a lack of clarity as to how the remaining requirements in AU 316 link to fraud-related requirements that will now be in other places throughout the reproposed standards. We do not believe that auditor performance will be improved by spreading fraud-related requirements throughout the standards. We believe that additional guidance for auditors on the types of procedures to perform in response to identified fraud risks, along with additional tools and enablers will yield better results in terms of the auditor's ability to detect material financial statement fraud.

Therefore, we recommend that the Board retain AU 316 in its entirety, and include references, as appropriate, to the existing requirements in AU 316 in other sections of the PCAOB auditing standards. This will still allow the Board to achieve its objective of integrating the consideration of fraud in the risk assessment standards, while also keeping a separate standard for the consideration of fraud throughout the audit process.

We note the Board has taken this approach in paragraph 15 of the reproposed standard, *The Auditor's Responses to the Risks of Material Misstatement,* where it references the procedures in AU 316 related to addressing the risk of management override of controls. We recommend that the Board consider this type of referencing back to AU 316 within all of the reproposed standards, resulting in a single fraud standard that appropriately references, and is referenced from, the reproposed risk assessment standards.

Effective Date

We commend the Board for responding to our comment in the original proposed standard and including an effective date in the reproposed standards. As we stated in our previous letter, when determining the final effective date of the reproposed standards, we ask the Board to consider providing sufficient time for firms to incorporate the standards into their respective methodologies and training programs prior to implementation.

Other Comments Related to the Reproposed Standards

We present below our more detailed comments specific to each of the seven reproposed standards and the conforming amendments to the PCAOB standards. To facilitate your review, consistent with our previous letter, we have referenced the detailed comments to the related overall comment in the body of our letter. In some instances, however, a comment does not relate back directly to an overall comment, in which case no reference is provided.

Appendix 1: Audit Risk in an Audit of Financial Statements

- We recommend the following revision to paragraph 1:

  This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit ~~and~~ *or* an audit of financial statements only.

- Paragraph 5 defines the risk of material misstatement as the "risk that the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial reporting framework." This definition contrasts the ISA 200 definition of the risk of material misstatement, which says "the risk that the financial statements are materially misstated prior to the audit." The ISA 200 definition makes it clear that the risk of material misstatement is the entity's risk. We believe that this concept is important to include and therefore recommend adding the words "prior to the audit" to the first sentence of paragraph 5. *[Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards]*

- The Paragraph 7 definition of inherent risk and control risk, and the paragraph 9 definition of detection risk, each include a statement that the risk is the risk "individually or in combination with other misstatements." The definitions as they currently read may be interpreted by the auditor as a requirement to consider whether the combination of dissimilar risks will result in a material misstatement. In assessing inherent risk and control risk at the assertion level, we believe that the auditor should consider only risks of material misstatement that are related to a particular assertion as opposed to assessing them in combination with other unrelated risks. Therefore, we recommend the definitions in paragraph 7 and paragraph 9 replace the word "combination" with "aggregate" as this term more clearly indicates the various types of risk that should be considered. The use of "aggregate" in these definitions is also consistent with the way the ISAs and SASs define these terms. *[Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards]*

- The reproposed standard in paragraphs 9 and 10 discuss each of the components of the audit risk model including inherent risk, control risk, and detection risk; however, the standard does not link these concepts together. We believe that discussion on the relationship of these concepts is necessary for the auditor to determine the acceptable level of detection risk for the financial statement assertions which is then used to determine the nature, timing and extent of substantive auditing procedures. We therefore recommend the Board include the guidance in AU 319 *Consideration of Internal Control in a Financial Statement Audit* paragraph .81 which states "The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for the financial statement assertions" as the second sentence of paragraph 9 of the reproposed standard in order to appropriately describe the audit risk model.

Appendix 2: Audit Planning and Supervision

- The Note to paragraph 6 includes a requirement of the auditor. We recommend the Board consider including guidance in this Note as a separate paragraph in the reproposed standard. *[Requirements within Notes and Appendices]*

- We recommend the following revisions to paragraph 7 as the matters listed are matters that are important to the *audit* of the company's financial statements and are matters the auditor typically *considers* in planning an audit engagement but generally would not entail an evaluation. We therefore recommend the following revision to paragraph 7: *[Clarification of Terms Used in PCAOB Standards]*

  "the auditor should *consider* ~~evaluate~~ whether the following matters are important to the *audit of the* company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures."

- It is not appropriate to include the reference to "and internal control over financial reporting" in paragraph 7 as the Board has indicated that these reproposed standards exclude requirements specific to audits of internal control over financial reporting. In addition, the following bullets from paragraph 7 appear to only relate to matters that would be important to an audit of internal control over financial reporting. Therefore, we recommend the Board review these bullets to determine if they are required for audits of financial statements:

  - The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;

  - Public information about the company relevant to the evaluation of.... the effectiveness of the company's internal control over financial reporting;

In addition to considering whether the following matter is important to a financial statement audit, if the Board concludes that this matter is important to a financial statement audit, we believe the following revision is necessary to make it clear that it pertains to the *auditor's judgments*, which is consistent with the bullet point in paragraph 7 related to materiality:

- *The auditor's* ~~P~~preliminary judgments about the effectiveness of internal control over financial reporting

- Paragraph 10a requires the auditor to develop and document the nature, "timing" and extent of risk assessment procedures. We do not believe it is necessary to document the "timing" of such procedures, and we further believe that this would be impractical as risk assessment is an ongoing process that occurs throughout the execution of the audit. Further, the related guidance in AU 311 *Planning an Audit* (Redrafted) (AU 311) paragraph 9 does not include this requirement. We recommend the reference to "timing" within paragraph 10a be removed. *[Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards]*

- Paragraphs 11-14 discuss the auditor's responsibilities with respect to multi-location engagements. However, we note that in the release text in Appendix 9 of the reproprosed standards, the Board states that the provisions in these paragraphs "are applicable to all multi-location audits, not just group audits." This statement could be interpreted to indicate that the PCAOB intends the requirements in these paragraphs to apply to situations where the principle auditor makes reference to the work of another auditor. We believe that this requirement would cause unnecessary duplication in audit effort without a corresponding increase to audit quality. We recommend the PCAOB clarify its intent with regards to the applicability of these requirements and as necessary modify the requirements within paragraphs 11-14 to reduce any unnecessary duplication of audit efforts. *[PCAOB Standards Setting Process]*

- Paragraph 14 of this reproposed standard is an example of incorporating unpredictability in a multi-location environment as discussed in paragraph 5 of reproposed standard *The Auditor's Responses to the Risks of Material Misstatement;* however, a presumptively mandatory requirement has been added, which we do not believe is necessary. We do not believe that it is necessary for the standards to prescribe how the auditor should incorporate an element of unpredictability for multi-location audits. Therefore, we suggest that the Board consider removing the presumptively mandatory requirement and, rather, including this as an example within paragraph 5 of the reproposed standard, *The Auditor's Responses to the Risks of Material Misstatement.*

Appendix 3: Consideration of Materiality in Planning and Performing an Audit

- Paragraph 3 states "it ordinarily is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors." The use of the term "ordinarily" leads the auditor to believe that there are situations in which it would be appropriate to design audit procedures based solely on qualitative factors. We believe that language in AU section 312 *Materiality in Planning and Performing an Audit* (Redrafted) (AU 312) paragraph 6 that states the following "Although it is not practical to design audit procedures to detect misstatements that could be material solely because of their nature (that is, qualitative considerations), the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements" would be more appropriate as we do not believe that it is practical to design audit procedures based solely on qualitative factors. *[Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards]*

- Paragraph 6 states:

  When planning the audit, the auditor should establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This includes consideration of the company's earnings and other relevant factors.

  We believe that there are certain situations when it is appropriate for the materiality level for the financial statements to be based upon factors other than earnings. In applying this requirement, it may be interpreted by auditors that the established materiality level should always be based upon earnings. Therefore we recommend the Board clarify this requirement.

- Paragraph 7 requires the auditor to evaluate whether "there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. If so, the auditor should establish separate materiality levels for those accounts or disclosures." We believe that materiality is a concept that should be applied to the financial statements as a whole and not influenced by any particular account or disclosure. Establishing different materiality amounts for different accounts is inconsistent with this concept and could result in a significant level of audit effort being applied at a more granular level and may result in the auditor focusing more efforts on what is material at the account or disclosure level rather than considering what is material to the financial statements as a whole. We believe this would result in what could be virtually never ending effort in evaluating audit differences and whether they are material to the financial statements as a whole. This increase in audit effort in establishing different materiality levels at both the financial statement as a whole and at the account and disclosure level and in evaluating whether audit differences are material at each of these levels at the end of an audit may not result in a commensurate increase in audit quality. In addition, we believe this concept is embedded in the requirement in paragraph 8 that states "the auditor should determine the amount or amounts of tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level." This requirement is sufficient to address the risk that misstatements of lesser amounts than materiality established for the financial statements as a whole are appropriately identified when performing the audit. We therefore, recommend the Board remove paragraph 7 from the reproposed standard.

- Paragraphs 8 and 9 use the term "tolerable misstatement," which is also used in AU350 *Audit Sampling* (AU350). However, AU350.18 defines tolerable misstatement for purposes of the sample as the maximum monetary misstatement for the balance or class while the reproposed standard requires the auditor to determine the amount or amounts of "tolerable misstatement" for purposes of assessing risks of material misstatement at the account or disclosure level. We believe that using the same term, with different meanings, in the audit sampling guidance and the risk assessment guidance will result in confusion for auditors. We recommend the PCAOB consider using different terminology in the risk assessment standards, such as "performance materiality." This term is consistent with the terminology used in ISA 320 paragraph 11 and AU 312 paragraph 11. The use of this term in the reproposed standards would reduce the confusion of having "tolerable misstatement" applied by the auditor in two different contexts. *[Clarification of the Terms Used in the PCAOB Standards]*

Appendix 4: Identifying and Assessing Risks of Material Misstatement

- We recommend the Board consider including an additional statement within paragraph 3, the objective of the reproposed standard, which emphasizes that the auditor's identification and assessment of risks of material misstatements is "through understanding the entity and its environment, including the entity's internal control." This language is consistent with ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* and would link to the requirements discussed within the reproposed standard in paragraphs 7 and 8. *[Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards]*

- The reference in footnote 3 refers to a definition of *fraud* in AU 316. As the Board has integrated aspects of AU 316 into the reproposed standards, we suggest that the Board include this definition of fraud in Appendix A of the reproposed standard and include among its conforming amendments the following change to the last sentence of AU 316.05 to clarify that the term "fraud" as used in the Board's standards is an act that results in a material misstatement of the financial statements:

  For purposes of *PCAOB auditing standards* ~~the section,~~ *fraud* is an intentional act that results in material misstatement in the financial statement that are the subject of an audit.

- Paragraph 7 requires the auditor to "obtain an understanding of the company and its environment ("understanding of the company") to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement." Since none of the bullets in paragraph 7 appear to be an "event, condition or company activity", we ask the Board to provide examples of the types of events, conditions and company activities that might be considered to have a reasonable expectation of having a significant effect on the risks of material misstatement so that the auditor is able to understand the threshold of when such events are considered to have a significant effect on the risks of material misstatement. Alternatively, we suggest that the Board revise paragraph 7 as follows:

  "The auditor should obtain an understanding of the company and its environment ("understanding of the company") to ~~understand the events, conditions and company activities that might be reasonably expected to have a significant effect on~~ *assist the auditor in identifying and assessing* the risks of material misstatement."

- The use of the terms "encompasses" and "includes" in paragraphs 9, 10, and 24 may be confusing for auditors in determining whether the Board meant all of the matters are required to be considered. If this is the intent of the Board, we recommend the Board consider using "should" instead of "encompasses" and "includes" so that the requirements are more clearly understood by the auditor. *[Clarification of Terms Used in PCAOB Standards]*

- We recommend the following revision to the first note to paragraph 10:

  "The size and complexity of a company might affect the risks of *material* misstatement and how the company addresses those risks."

  We also recommend that the Board review the reproposed standards for other instances where the Board uses "those risks" to define "risks of material misstatement" to ensure that when this shorthand phrase is used, it is clear to the auditor that "those risks" are "risks of material misstatement."

- The second Note to paragraph 10 states:

  "The auditor should take into account the information gathered while obtaining an understanding of the nature of the company when determining the existence of related parties..."

  We recommend the Board consider including the note as a separate paragraph within the standard as there is an embedded requirement contained within the Note that makes it difficult for the auditor to reference and determine that it is appropriately applied. *[Requirements within Notes and Appendices]*

- The procedures required of the auditor in paragraph 11 appear to be very prescriptive and limiting of the auditor's ability to apply judgment when determining the appropriate procedures that are necessary to be performed as part of understanding the company, since certain of these procedures may be less relevant for certain public companies (e.g., earnings calls may be less relevant for companies that are not actively followed by analysts) and may be endless for others (e.g., the number of blog sites and other publicly available information for certain companies is virtually endless, such that reading all of such public information may well be impossible and, in some cases, of little value) . We believe that the listed procedures within paragraph 11 would be more appropriate to be referenced as examples of procedures that may be performed to meet the requirements of paragraph 10 and therefore suggest that the Board replace the phrase "should consider" with "may consider" within the first sentence of paragraph 11.

- We suggest the following revision to paragraph 11 to be consistent with the overall requirement to obtain an understanding of the company and its environment ("understanding the company") in paragraph 7:

  Reading public information about the company relevant to the ~~evaluation of the likelihood of material financial statement~~ *identification of risks of material* misstatements ~~and the effectiveness of the company's internal control over financial reporting~~,

- Paragraphs 13 and 68 discuss requirements for the auditor to consider the risk of omitted or incomplete disclosures and to identify the necessary disclosures for the company's financial statements. We recommend that the Board clarify that this evaluation is performed in the context of the disclosures that are required by the company's financial reporting framework.

- Paragraph 15 of the reproposed standard provides examples of "which business risks might result in material misstatement of the financial statements." The examples provided within this paragraph are examples of business risks; however, the examples do not demonstrate how the business risks may result in material misstatements to the financial statements. We recommend the Board consider expanding the examples to demonstrate how these example business risks might reasonably be expected to result in material misstatements. This will allow auditors to better understand the Board's view of business risks and when they could reasonably be expected to result in material misstatement of the financial statements, so that the execution of these risk assessment procedures are more likely to be consistently applied in all audits.

- In the second Note to paragraph 20, it is not clear whether a walkthrough would be sufficient to determine whether a control has been implemented. Paragraph 64 seems to imply this as it states that "performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 62," and one of the objectives in paragraph 62 is to "Identify the controls that management has implemented to address these potential misstatements." Because of this lack of clarity, we recommend the Board clarify that a walkthrough would be sufficient to determine whether a control has been implemented by adding the following sentence to the end of the second Note to paragraph 20:

  Ordinarily, performing walkthroughs as described in paragraphs 64 and 65 are sufficient to determine whether a control has been implemented.

- Paragraph 28 requires the auditor to "obtain an understanding of the information system, including the related business processes, relevant to financial reporting." Paragraph 30 further states that "Obtaining an understanding of the company's business processes assists the auditor in obtaining an understanding of how transactions are initiated, authorized, processed and recorded." While there may be some cases in which obtaining an understanding of the business processes may be necessary for the auditor, or may assist the auditor, in obtaining an understanding of how transactions are initiated, authorized, processed and recorded, we believe that in most cases, this understanding can be gained without the need to gain an understanding of the company's business processes. As a result, we do not believe that obtaining an understanding of the company's business processes should be required. We do agree that obtaining an understanding of how transactions are initiated, authorized, processed and recorded is necessary to achieve the overall objective of an audit, and believe that gaining an understanding of related business processes may be an example of a way in which to obtain such understanding. We therefore recommend the Board remove the phrase ",including the related business processes," from paragraph 29 of the reproposed requirement, and modify paragraph 30 to indicate that obtaining an understanding of the company's business processes "may assist" the auditor in obtaining an understanding of how transactions are initiated, authorized, processed and recorded.

- Paragraph 33 requires the auditor to obtain an understanding of control activities that is "sufficient to assess the factors that affect the risks of material misstatement." Currently, the reproposed standards do not establish a framework for evaluating the sufficiency of this understanding. We are concerned that this requirement could be interpreted by the auditor as a requirement to consider **all** of the company's control activities regardless of their nexus to financial reporting and to the audit. Such a requirement may result in a significant increase in audit effort for audits of financial statements, where an auditor ordinarily would only be required to obtain an understanding of controls sufficient to plan the audit, and as a result, may develop an audit strategy that does not rely on a company's control activities. We do not believe that this increase in effort for financial statement only audits corresponds to an increase in audit quality. Paragraph 20 states that obtaining an understanding of internal control includes evaluating controls "that are relevant to the audit," which we believe provides an appropriate framework for determining the appropriate level of understanding. We recommend the Board consider clarifying the requirements in the reproposed standard such that the auditor's responsibility is for understanding the control activities that are relevant to the audit.

- We recommend the following revision to paragraph 42:

  If the *engagement partner* ~~auditor~~ has obtained other information relevant to identifying risks of material misstatement through other engagements performed for the company, the auditor should take that into account in identifying risks of material misstatement.

  The Note to paragraph 56a. should reference paragraphs 66-70 rather than paragraphs 67-70.

- The Note to paragraph 56c. states:

  "the auditor should evaluate how risks at the financial statement level could affect risks of misstatement at the assertion level."

  We recommend the Board consider including this requirement as additional discussion within paragraph 56c. *[Requirements within Notes and Appendices].*

  We also recommend that the Board review the proposed standards to assure that the word "material" is appropriately placed after the words "risks of" and before the word "misstatement" throughout the proposed standards.

- Paragraphs 62-64 contain requirements related to understanding likely sources of misstatement. While these are largely consistent with AS 5, in a financial statement audit an auditor may elect not to rely on a company's controls. The requirements in paragraph 62, for example, for the auditor to identify controls that management has implemented go beyond what should be required in a financial statement only audit. We recommend the Board consider whether the requirements to identify all the controls management has implemented to address potential misstatements significantly enhances the auditor's ability to plan and perform a financial statement only audit given the potential increase in costs this identification may require.

- We recommend the following revision to the second bullet of paragraph 62:

  ~~Verify that the auditor has identified~~ *Identify* the points within the company's processes at which a misstatement - including a misstatement due to fraud - could arise that, individually or in combination with other misstatements, would be material;

- The reference made in paragraph 66 to the "preceding paragraph" should actually say "earlier in this paragraph" as the illustrative risk factors are discussed within paragraph 66 and not within paragraph 65.

- We recommend the following revision to paragraph 67:

  ~~The auditor **should** not assume that~~ All of the conditions discussed in paragraph 66 ~~must~~ *are not required to* be observed or evident to conclude that a fraud risk exists. The auditor might conclude that a fraud risk exists even when only one of these three conditions is present.

- We believe the Appendix A definition of significant risk in paragraph A5 should include the concept that a significant risk is based upon those risks that the auditor determines need special audit consideration. Therefore, we recommend the Board consider the following revision to the definition of significant risk which is also consistent with the definition of significant risk in AU 314 and ISA 315:

  A*n identified and assessed* risk of material misstatement that *the auditor determines* requires special audit consideration.

- The information included in Appendix B *Consideration of Manual and Automated Systems and Controls* includes several presumptively mandatory requirements that we believe make it difficult for auditors to reference and determine that they are appropriately applied in an audit. We also believe that the content of the appendix is important for auditors to consider during the risk assessment process and therefore recommend the Board incorporate the requirements and guidance in Appendix B within the reproposed standard. *[Requirements within Notes and Appendices]*

Appendix 5: The Auditor's Responses to the Risks of Material Misstatement

- In order to align the objective of this reproposed standard with the objectives of the entire suite of reproposed standards (i.e., that the auditor's procedures are designed to be responsive to the assessed risks of material misstatement), we recommend the following revision to paragraphs 1 and 2:

  The standard establishes requirements and provides direction regarding designing and implementing appropriate responses to the *assessed* risks of material misstatement.

  The objective of the auditor is to address the *assessed* risks of material misstatement through appropriate overall responses and audit procedures.

  We also recommend that the Board consider changing the title of the proposed standard to add the word "assessed" to the title.

- The Board discusses in appendix 9, in relation to the overall responses to risk, that paragraph 5c. of this reproposed standard is intended to extend the requirement of incorporating an element of unpredictability into the audit, such that the auditor should incorporate an element of unpredictability as part of the response to the risks of material misstatement including the risk of fraud. We do not believe that the requirements within paragraph 5c. will be applied consistent with this interpretation, unless this interpretive guidance is included within the reproposed standards. Further, we do not believe that it is appropriate or necessary to incorporate an element of unpredictability to risks other than fraud risks in the audit, as this requirement would increase the audit effort without a corresponding increase in audit quality. Therefore, we recommend that the Board consider incorporating elements of unpredictability in the selection of audit procedures in the context of responding to the risk of material misstatement due to fraud only. *[PCAOB Standards Setting Process]*

- Paragraph 6 states the following:

  The auditor should also evaluate whether it is necessary to make pervasive changes to the nature, timing, or extent of audit procedures to adequately address the assessed risks of material misstatement. Examples of such pervasive changes include performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence. We note that the original reproposed standard used the term "general" to describe these types of changes. It is unclear why the Board changed the term from 'general' to 'pervasive' and whether there was any intended change to auditor performance. We recommend the Board consider whether a definition of the term "pervasive" is necessary to clarify the point. *[Clarification of Terms Used in PCAOB Standards]*

- Paragraph 9c. relates to integrated audits only, therefore we recommend the Board include this requirement within AS 5 and not in the reproposed standard as the requirement is not relevant to financial statement only audits. *[Conforming Changes to Auditing Standards No. 5]*

- The Note to paragraph 23 states:

  To obtain evidence about whether a control is effective, the control *must* be tested directly;

  This requirement is consistent with AS 5. However, we suggest including additional discussion to clarify the meaning of "tested directly." For example, the Board could consider adding the concept that while the absence of misstatements does not support the effective operation of a control, the absence of misstatements can inform the risk assessment associated with a control and, as such, affect the nature, timing and extent of testing of a control for operating effectiveness. We believe this additional clarification would be helpful to the auditor in better understanding what is meant by "tested directly." *[Clarification of Terms Used in PCAOB Standards]*

  We also recommend that the Board consider including this requirement either within paragraph 23 or as a separate paragraph within the reproposed standard in order for the auditor to be able to better identify and refer to the requirement within the reproposed standard. *[Requirements within Notes and Appendices]*

- The requirements in paragraph 31 under the heading "Using Audit Evidence Obtained in Past Audits" are largely consistent with the requirements of AS 5 paragraphs 47 and 58. However, the requirements as they are included within the reproposed standard could be overly burdensome for the auditor as they could be interpreted as a requirement to evaluate and document the auditor's considerations of all controls tested in connection with the prior year audit. The requirement within AS 5 is intended to provide for the auditor's experience in prior years to inform the current year assessment of risk, which in turn affects the nature, timing and extent of testing necessary.

We believe it is necessary to include these additional considerations from AS 5 paragraphs 47 and 58 in the reproposed standard to better articulate the requirement. *[Conforming Changes to Auditing Standard No. 5]*

- Paragraph 34 provides the auditor with direction when control deficiencies are detected. The proposed standard however does not provide direction for the auditor when a control deviation occurs. We recommend the Board include the guidance in AS 5 paragraph 48 which provides direction for the auditor when a control deviation is identified. *[Conforming Changes to Auditing Standard No. 5]*

- We suggest removing the presumptively mandatory requirement from the second sentence of paragraph 45. We believe the requirement in the first sentence provides the appropriate level of direction for the auditor. The detailed procedures to perform should be determined by the auditor based on professional judgment.

Appendix 6: Evaluating Audit Results

- The Note to paragraph 6b. includes a requirement for the auditor to modify the audit procedures or perform additional procedures when there is discovery of a previously unidentified risk of material misstatement.

  The second Note to paragraph 17 includes a requirement for the auditor to take into account certain factors when the reassessment of materiality results in a lower amount.

  The Note to paragraph 25a. includes a requirement for the auditor to obtain an understanding of the reasons management did not correct audit misstatements.

  Due to the importance of each of these requirements, we recommend the Board consider including these notes as separate paragraphs within the reproposed standard. *[Requirements within Notes and Appendices]*

- Paragraph 15 includes guidance for the auditor to communicate accumulated misstatements to management on a timely basis to provide them with an opportunity to correct them. The original proposed standard also included the requirement for the auditor to request that management correct the misstatements. This requirement has been removed from the reproposed standards. Both ISA 450, *Evaluation of Misstatements Identified during the Audit* and AU 312 paragraphs 7-9, include a requirement for the auditor to understand management's rationale for not recording identified misstatements and the effect on the audit. Requiring the auditor to make a direct request of management to correct misstatements will encourage management to make such corrections in the current period. Therefore, we believe this is an important requirement to retain and recommend the PCAOB include the requirements from ISA 450 within the reproposed standard. [*Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards]*

- We recommend the following revision to footnote 11 of paragraph 20:

  Misstatements *also* include omission or incomplete presentation of disclosures.

- We do not believe that Appendix B *Qualitative Factors Related to the Evaluation of the Materiality of Uncorrected Misstatements* has been referenced within the body of the reproposed standard. We suggest that the Board add such a reference (for example, to paragraph 17) to clarify the intended purpose of the Appendix.

- Fraud risk was defined in paragraph 4d. of the reproposed standard. Therefore we recommend the following revision to paragraph 26:

  Also, the auditor should evaluate whether the auditor's risk assessments, including in particular, the assessment of ~~risks of material misstatement due to~~ fraud *risks,* and the related audit responses remain appropriate.

- The Note to paragraph 31 states:

  if the financial statements, including accompanying notes, fail to disclose information that is required by the applicable financial reporting framework, the auditor should express a qualified or adverse opinion and should provide the information in the report if practicable, unless its omission from the report is recognized as appropriate by a specific auditing standard.

  The description above may lead auditors to believe that it is necessary to disclose information that is not material to the financial statements and if this information is not disclosed then the auditor should express a qualified or adverse opinion. We therefore ask the Board to clarify that there is a materiality threshold for determining the appropriate disclosures in the financial statements.

- Paragraph 37 relates to audits of internal control over financial reporting only; therefore, we recommend the Board consider removing this from the reproposed standard, consistent with the discussion in Paragraph 1 of Appendix 1 of the reproposed standards, and retaining the concept within AS 5. *[Conforming Changes to Auditing Standard No. 5]*

- The definition of "misstatement" in paragraph A2 of Appendix A as it is currently drafted implies that the definition is defining "material misstatement" as opposed to "misstatement." We recommend that the Board consider moving the second sentence of the definition that deals simply with "misstatement" to the first sentence of the paragraph and include the following revision:

  A misstatement ~~may relate to~~ *is* a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework.

  These changes will provide a better understanding for the auditor of what defines a "misstatement" and the implications to the financial statements when misstatements are material.

Appendix 7: Audit Evidence

- We recommend the following revision to paragraph 12 to be consistent with the description used in paragraph 62 of the reproposed standard, *Identifying and Assessing Risks of Material Misstatement*:

  if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated, <u>*individually or in aggregate with other misstatements*</u>.

- Paragraph 16 discusses the limited nature of audit evidence that can be obtained through the use of observation as an audit procedure, and provides the auditor's observation of inventory counting as an example of an observation. The performance of an inventory observation includes not only performing observations but also making inquiries and inspecting evidence of the existence of inventory, and thus provides considerably more evidence than the type of observation that might provide more limited evidence. Therefore we recommend the Board include an example of performing observations that is something other than performing an inventory observation.

  A different example of observation that the PCAOB may consider is the auditor's observation of the presentation of the Chief Financial Officer's explanation of the key variations in the quarterly financial results to the Audit Committee or the auditor's observation of the accounts receivable manager checking the credit limits of a customer prior to processing an order from the customer.

- The word "written" related to confirmations was deleted from the original proposed standard in paragraph 18. We believe that "written" is important to include within paragraph 18 as it relates to confirmations and without this word it could have effects on the evaluation of information provided from third parties as part of the audit. We therefore recommend the Board consider the following revision to paragraph 18:

  A confirmation represents audit evidence obtained by the auditor as a direct <u>*written*</u> response to the auditor from a third party.

- Paragraph 21 does not include "scanning" as part of analytical procedures. We believe this is an important procedure for the auditor to consider. Therefore, we recommend the Board consider including "scanning" as an analytical procedure and also incorporate the scanning guidance from AU section 326, *Audit Evidence* (Redrafted) paragraph A22 within the reproposed standard. *[Improved Transparency of the Standards Setting Process and the Relationship of the PCAOB Standards to Other Auditing Standards]*

Appendix 8: Conforming Amendments

- Paragraph 1 of the reproposed standard, *Audit Evidence*, uses the phrase "sufficient appropriate audit evidence." We note that the Board's conforming amendments would replace the term "competent" with the term "appropriate" throughout the extant standards. The resulting phrase in many instances is "sufficient appropriate evidential matter." Audit evidence is defined in the reproposed standards; however, "evidential matter" is not. Therefore, we believe that the conforming amendments should be revised to replace the phrase "sufficient competent evidential matter" with "sufficient appropriate audit evidence" to be consistent with the phrase used in the reproposed standard, *Audit Evidence*.

- Appendix 9 states that AU sections 350.23 to 350.38 have been amended to explain more specifically how the principles in the standard apply for determining sample sizes when nonstatistical sampling approaches are used. To this end, appendix 8 proposes to add paragraph .23A and to add a sentence to the end of paragraph .38 of AU section 350, *Audit Sampling*, which includes the following:

  When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

  We believe that this addition to AU section 350 may lead auditors to infer that it is necessary to calculate sample sizes using both statistical and nonstatistical approaches, in all circumstances, in order to be in a position to be able to compare the sample sizes. We suggest that the PCAOB remove the phrase "or larger than" from the second sentence in the proposed sentence and add footnote 5 from the ASB's revised AU section 350.23 to clarify that is not the intent.

- The conforming amendment to AS 3 paragraph 9 adds additional documentation requirements for the auditor to document risk assessment procedures and responses to risk of misstatement that "include (1) a summary of the identified risks of [material] misstatement and the auditor's assessment of risks of material misstatement at the financial statement and assertions levels and (2) the auditor's responses to the risks of material misstatement, including linkage of the responses to those risks." We believe these additional documentation requirements will result in an unnecessary linkage and a matrix- like mentality to documentation that will not improve audit quality but will likely increase the cost of performing audits.

  In addition to reconsidering these documentation requirements, we also recommend the Board consider adding additional documentation requirements within the reproposed standards where the PCAOB believes special documentation considerations, beyond the requirements of AS3, are warranted. This approach is also consistent with the ISAs and SASs approach to establishing documentation requirements for the auditor.

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements (AS 5)*

We recommend the following conforming amendments to AS 5. *[Conforming Changes to Auditing Standard No. 5]*

a. Delete paragraphs and Notes 28, 29,30, 36, and 38 (guidance included in corresponding paragraphs 56e, 57, 59,60, 63, 65 of reproposed standard *Identifying and Assessing Risks of Material Misstatement)*

b. Delete footnote 13 (guidance included in footnote 28 of the reproposed standard *Identifying and Assessing Risks of Material Misstatement)*

c. Delete the guidance in paragraph 33 and replace with the following sentence:

   After applying the guidance within paragraph 61 of reproposed standard *Identifying and Assessing Risks of Material Misstatement* refer to the direction in Appendix B for multiple location scoping decisions.

d. Delete the first 2 bullets included within paragraph 34 and include a footnote reference within paragraph 34 to reproposed standard *Identifying and Assessing Risks of Material Misstatement* paragraph 62 so that the auditor applies the guidance in AS 5 in combination with paragraph 34 of the reproposed standard for integrated audits.

e. Delete paragraphs 42, 43,45, 49, 50, and 51 (guidance included in corresponding paragraphs 19, 20,22, 23, 24, and 25 of reproposed standard *The Auditor's Responses to Risks of Material Misstatement)*

f. Delete paragraph 44 and include the related note as part of the guidance included in reproposed standard *The Auditor's Responses to Risks of Material Misstatement* paragraph 21.

g. Delete paragraph 47 and incorporate the related notes within paragraph 31 of the reproposed standard *The Auditor's Responses to Risks of Material Misstatement*

h. Delete bullets from 47 and 58 that are included within the reproposed standard *The Auditor's Responses to Risks of Material Misstatement* paragraph 31

Federation of European Accountants
Fédération des Experts comptables Européens

Office of the Secretary
PCAOB
1666 K Street N.W.
Washington D.C 20006-2803
USA

comments@pcaobus.org

2 March 2010

Ref.: AUD/HvD/LA/SH

Dear Sir or Madam,

Re: FEE Comments on the PCAOB Release No. 2009-007: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards

FEE (the Federation of European Accountants) is pleased to provide you with its comments on PCAOB Proposed Auditing Standards related to The Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards.

FEE welcomes an improved set of proposed standards and the decision by the PCAOB to re-expose them. FEE also appreciates the approach to setting standards on audit risk in the US that is based on an international approach and the improved statement of the differences between PCAOB standards and the International Standards on Auditing (ISAs). As a result of increased global acceptance of ISAs, they have become the global benchmark for auditing standards. Devoting efforts to quality standards and convergence in such a significant area in audit as audit risk will therefore be beneficial to all stakeholders.

FEE's comments on significant aspects of the proposed audit risk standards are set out below.

1. Convergence

The benchmark auditing standards are the clarified International Standards on Auditing (ISAs)

As mentioned in the FEE comment letter dated 18 February 2009 to the PCAOB Release No. 2008-006: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards, FEE has been advocating for the use of the (clarified) ISAs in the European Union (EU) for over ten years. In addition, the worldwide use of the ISAs has steadily expanded over the last few years, making ISAs the global benchmark auditing standards. In 2009, FEE has reconfirmed its support for ISAs in Europe in the FEE Policy Statement on International Standards on Auditing (ISAs)[1].

FEE fully supports the adoption of ISAs as the use of harmonized international auditing standards will serve to increase audit quality and enhance confidence in the reliability, comparability and consistency of financial statements.

In general, FEE believes that uniformity in auditing standards world-wide, to the maximum degree possible, is beneficial for capital market participants with cross-border interests and global activities and enhances the quality of audits based on globally accepted auditing standards at national level, including the acceptance of audit reports beyond home jurisdictions.

Aligning PCAOB auditing standards to ISAs

Therefore, FEE welcomes the PCAOB's initiative to align its standards with the clarified ISAs as a step towards the ultimate worldwide application of one set of auditing standards for capital market entities and also other entities.

We also reiterate our support for the update of the PCAOB's audit risk standards, reflecting the importance the PCAOB attaches, and is right to attach, to the new risk approach (i.e. risk assessment and responding to identified risk) to an audit which is already embedded in the ISAs.

The improved draft standards support to a greater extent than before further global convergence. In an environment of convergence to international accounting standards, the globalisation of auditing standards is also expected to facilitate consistency in the audit of financial statements. The alternative is cumbersome reconciliations covering differences in auditing standards that detract from an efficient and effective audit.

Towards globally accepted auditing standards or convergence?

We recognise that the PCAOB issues standards separately and different from those of the IAASB because the PCAOB standards need to take into account U.S. securities law and

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1 http://www.fee.be/fileupload/upload/Auditing%20and%20Assurance%20PS%20I%20International%20Standards%20on%20Auditing%20%28ISAs%29%20I%2009043014520092314 9.pdf

U.S. Securities and Exchange Commission (SEC) and other PCAOB rulemaking on these laws and the PCAOB has chosen for an integrated audit approach. Therefore we acknowledge that some differences between PCAOB standards and ISAs are inevitable.

However, we believe that it is not conducive to international convergence in auditing standards for the PCAOB to issue auditing standards that differ from the (clarified) ISAs at a technical level for other than these US legal reasons. The (clarified) ISAs reflect the product of an intensively overseen and thorough due process involving extensive consultation at an international level, including input from regulators, such as the PCAOB. Consequently, the ISAs are the most widely accepted benchmark of high quality auditing standards at an international level.

The differences as described in Appendix 10[2] go beyond additional US legal requirements. Although appendix 10 is helpful, in the light of convergence, FEE recommends that this appendix also articulates why the additional requirements are considered necessary and in particular whether the differences are necessary to address specific US requirements.

Considering this issue, FEE believes that deviations from ISAs should be limited to meeting the US legal requirements which would undoubtedly also result in a significant amount of unnecessary minor differences being eliminated.

Enhanced transparency on the remaining differences between PCAOB auditing standards and ISAs is desirable

FEE would encourage the PCAOB to more clearly indicate and explain where their standards are not based on ISAs. Such explanations would be very helpful for non-US practitioners, who use ISAs as their standard audit approach, but sometimes are required to conduct audits in accordance with PCAOB standards when reporting to US group auditors. This is not only the case for enhancing the efficiency and effectiveness of their audits, but also for educational and quality assurance reasons.

Therefore, FEE strongly encourages the PCAOB to consider these additional steps towards convergence before finalising these standards.

It would also be helpful if the PCAOB were to explain in more detail how the benefits of retaining the differences in the proposed standards are exceeding the costs of their retention. This would also enable the IAASB to appropriately include the PCAOB in their due process when the relevant ISAs are being considered for revision in the future.

2. Professional judgement and rigorousness of PCAOB standards

The PCAOB audit risk standards refer to professional due care and professional scepticism, which is specifically addressed in the proposed Auditing Standard No. 5 "*The*

[2] PCAOB exposure draft Appendix 10: Comparison of the Objectives and Requirements of Proposed Auditing Standards to the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

Auditor's Response to Risks of Material Misstatement", where it is highlighted that *"Due professional care requires the auditor to exercise professional scepticism[3]."*

The term *"professional judgement"* is not used in the proposed PCAOB standards. The discussion in PCAOB Appendix A9 and analysis of further amendments to the standards demonstrate that the PCAOB does not consider "*professional judgement*" as relevant to include which is highlighted by the following comments[4].

> *"As under the existing PCAOB standards, auditors would need to exercise judgment in fulfilling the requirements of the new proposed standards in the particular circumstances. Making references to judgment in selected portions of the standards, however, could be misinterpreted as indicating that judgment is required only in certain aspects of the audit. Instead of referring to judgment selectively, the new proposed standards set forth the principles necessary for meeting the requirements of the new proposed standards, and allow the auditor to determine the most appropriate way to comply with the requirements in the circumstances."*

FEE considers that the use of professional judgement when conducting audits is highly relevant. The requirements related to professional scepticism in the proposed PCAOB audit risk standards seem to be quite prescriptive and, therefore, may limit the auditor's ability to exercise professional judgement in assessing and responding to risk. FEE supports a more principles-based approach to audit risk, consistent with the ISAs, by applying the concept of professional judgement than the one currently promulgated in the proposed PCAOB audit risk standards.

3. Fraud

FEE would like to reiterate its comments on fraud made in the FEE comment letter dated 18 February 2009 to the PCAOB Release No. 2008-006: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards, as no additional guidance on fraud seems to have been included in the re-exposed standards. FEE pointed out that the lack of application material in connection with the fraud requirements could be a risk related to the efficiency of the audit.

4. Considerations Specific to Small Entities

The PCAOB has included some additional considerations specific to small entities by adding some notes.

FEE recommends that this issue is addressed to an even greater extent in a consistent way similar to the approach taken in the ISAs where all ISAs include a specific section addressing these considerations.

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[3] PCAOB Appendix 5 Proposed Auditing standard The Auditor's Response to Risks of Material Misstatement, paragraph 7

[4] PCAOB Appendix A9 – page 4

5. Objectives

Each of the PCAOB audit risk standards include some objectives, but not in a comparable way. Under ISAs the objectives are addressed in two different ways: generally in ISA 200[5] and in addition each ISA contains objectives for the particular subject matters addressed in that ISA. For example, the wording of the objective on page A5-1 states that the auditor is to address "*the risks of material misstatement*" whereas the requirements of that standard, which FEE supports, relate to "*the assessed risks of material misstatement*". As a result of this mismatch, an auditor complying fully with the requirements of the standard may not necessarily be in a position to meet the stated objective.

The PCAOB audit risk standards do not include a standard that is comparable to ISA 200. FEE commented on this issue in its comment letter dated 18 February 2009 highlighting that it was not clear whether the objectives included in each PCAOB audit risk standard would be comparable to the objectives in the comparable ISAs. Other respondents to the originally proposed PCAOB audit risk standards expressed similar views. Setting clear objectives in a manner consistent with ISA 200 would be very helpful in applying the proposed standards.

6. Due process

As part of its due process in developing auditing standards, the PCAOB re-exposes or invites again comments on standards previously proposed and commented on by interested parties. FEE welcomes this initiative as it enhances the involvement of stakeholders and significantly contributes to the quality of the final standards. Given the international significance of PCAOB standards, FEE believes that the standards require an adequate transparent due process throughout their development. As an additional step in the due process and depending on the significance of the amendments made based on comments received to this re-exposure, the PCAOB could consider re-exposing the audit risk standards one more time, especially in light of the importance of the issues discussed.

FEE is very supportive of further initiatives to improve the due process and especially its transparency and would encourage the PCAOB to engage in an even more active and transparent dialogue in the development phase of new standards with its stakeholders. This would provide more transparency in the standard setting process which could be achieved by:

- Providing a mark-up of the originally proposed standard to better illustrate the revisions made. This approach is followed by the IAASB;
- Clearer explanations of the further amendments made, which could for instance have been done via cross-referencing from Appendix 9 to the revised proposals;
- Providing a list of the significant changes in practice that are anticipated as a result of the revised standards; and

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[5] ISA 200: Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing

- Providing a discussion as to how the individual comments received have been addressed, and, where not addressed, the reasons for not having addressed them.

7. FEE previous and other comments

The re-exposed audit risk standards do not include an explanation as to how significant comments raised by respondents have been addressed. FEE has therefore not been able to clearly identify how the PCAOB has dealt with its comments made in February 2009 and we would therefore like to reiterate these points as we still believe that the issues addressed are significant when considering the application of standards on audit risk. The detailed comments made by FEE in its comment letter dated 18 February 2009 to the PCAOB Release No. 2008-006 were as follows:

- The distinction between audit procedures on a financial statements level and on an assertion level is not always drawn systematically in the Proposed Auditing Standards like it is done in the clarified ISAs;

- The distinction between requirements pertaining to management as opposed to those charged with governance or the board of directors is not always pronounced clearly in the Proposed Auditing Standards like it is included in the clarified ISAs;

- The introduction in the Proposed Auditing Standards of far reaching requirements to compensate for the lack of an auditing standard on group audits like ISA 600[6] makes the Proposed Auditing Standards to be less comprehensive and unduly burdensome;

- There are requirements for substantive procedures on *all* significant risks, with little scope for the combination of work on controls and analytical procedures as required by clarified ISAs; this may be onerous. Detailed substantive testing for significant risks is flawed logically; *detailed* checking is not the right response to significant risks;

- There is a great number of presumptively mandatory 'shoulds' in the Proposal Auditing Standards (a construction rejected by the IAASB).

The PCAOB is also proposing a number of amendments to its standard AS-3 "Audit Documentation" in addition to those proposed previously. These proposals stem from the results of the PCAOB's inspections rather than from comments received from respondents.

FEE believes that overly prescriptive documentation requirements, may not be conducive to enhancing audit quality, and indeed may be counterproductive. In this context we refer to our letter dated 20 January 2004 commenting on the then proposed AS-3 "Audit Documentation", in which we had previously expressed this view.

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[6] ISA 600: Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)

Avenue d'Auderghem 22-28 • B-1040 Brussels • Tel: +32 (0)2 285 40 85 • Fax: +32 (0)2 231 11 12 • secretariat@fee.be • www.fee.be

For further information on this FEE[7] letter, please contact Mrs. Hilde Blomme at +32 2 285 40 77 or via email at hilde.blomme@fee.be from the FEE Secretariat.

Yours sincerely,

Hans van Damme
President

[7] FEE is the Fédération des Experts comptables Européens (Federation of European Accountants). It represents 43 professional institutes of accountants and auditors from 32 European countries, including all of the 27 European Union (EU) Member States. In representing the European accountancy profession, FEE recognises the public interest. It has a combined membership of more than 500.000 professional accountants, working in different capacities in public practice, small and big firms, government and education, who all contribute to a more efficient, transparent and sustainable European economy.

FEE's objectives are:

- To promote and advance the interests of the European accountancy profession in the broadest sense recognising the public interest in the work of the profession;
- To work towards the enhancement, harmonisation and liberalisation of the practice and regulation of accountancy, statutory audit and financial reporting in Europe in both the public and private sector, taking account of developments at a worldwide level and, where necessary, promoting and defending specific European interests;
- To promote co-operation among the professional accountancy bodies in Europe in relation to issues of common interest in both the public and private sector;
- To identify developments that may have an impact on the practice of accountancy, statutory audit and financial reporting at an early stage, to advise Member Bodies of such developments and, in conjunction with Member Bodies, to seek to influence the outcome;
- To be the sole representative and consultative organisation of the European accountancy profession in relation to the EU institutions;
- To represent the European accountancy profession at the international level.

Grant Thornton

March 2, 2010

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Audit – Tax – Advisory

Grant Thornton LLP
175 W Jackson Boulevard, 20th Floor
Chicago, IL 60604-2687

T 312.856.0200
F 312 565 4719
www.GrantThornton.com

Re: PCAOB Rulemaking Docket Matter No. 026, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Related Amendments to PCAOB Standards*

Dear Board Members and Staff:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (Board or PCAOB) *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Related Amendments to PCAOB Standards.* We were pleased to see that the re-proposed standards more closely align with International Standards on Auditing (ISA) and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements.*

As a member of the Center for Audit Quality (CAQ), we participated in the development of the CAQ's letter of comment in response to the re-proposed standards. Overall, we support the comments in the CAQ's letter, and therefore, we minimized repeating the same comments herein. We respectfully submit our comments and recommendations below.

Convergence

We continue to support the PCAOB's convergence with the ISAs. Yet, we observed differences in the language used to describe some requirements where we believe differences need not exist. When the requirements are the same, but the language differs, we are concerned that there will be unintended disparity in application. At a minimum, much needless effort will be expended by auditors in analyzing what the differences mean. Minimizing language differences will enhance audit quality by promoting consistency in application. In this regard, when additional requirements are needed for audits of issuers, we recommend including the incremental requirements, rather than modifying the language in the ISAs.

In addition, we appreciate the analysis of differences with the ISAs. We can only assume that if there are language differences, and the Board has not highlighted the requirement as a difference, then the expected performance must be the same. However, as detailed in our comments below, we identified certain inconsistencies in the requirements that are highlighted as differences. In these situations, if the language was more consistent and incremental requirements were separately included, the analysis would contain true differences making it easier for the auditor to understand the Board's intent.

General Areas of Comment

Overall, we support the issuance of the proposed standards. In addition to the comments in the CAQ letter and our responses to the Board's request for specific comments below, we have the following observations:

- With respect to the definitions in the appendices to the proposed standards, we request the Board to reconsider the phrase "for purposes of this standard." Many of the defined terms pertain to other standards as well. A glossary of terms may be helpful.

- In future releases, we suggest that the Board:
  - Avoid labeling release text as an appendix. The PCAOB has previously stated that appendices to a standard "…are an integral part of the standard and carry the same authoritative weight as the body of the standard." By labeling the release text something different, this would eliminate the misperception that the release text is an appendix that is part of the standard.
  - Eliminate interpreting the requirements in release text. Although we find the Board's analysis of proposed standards and disposition of comments received helpful, information that is essential in applying the requirements, or requirements themselves, should be contained within auditing standards to mitigate differences in practice.
  - Consider the need to provide application guidance. In many cases, application guidance is essential to fully understand the requirements. With the elimination of application guidance and the various language differences, the Board complicates the process of understanding and applying PCAOB standards as intended.

The following includes our response to the Board's specific question.

1. Are the objectives in the new proposed standards useful in providing context for the requirements in the standards?
   We support the objectives in the proposed standards and believe they are useful in providing context for the requirements. However, as the Board continues to revise its interim standards, we believe that the Board should eventually consider an "umbrella" standard that addresses the overall objectives of the auditor and the relationship of those objectives to the objectives in each of the Board's standards, similar to ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

Appendix 1 - Audit Risk

The following includes our responses to the Board's specific questions.

2. Does the new proposed standard on audit risk describe clearly the concept of audit risk and its components?
   The new proposed standard is clear regarding the concept of audit risk and its components, except for the last sentence in paragraph 3, which we believe is awkward and can be misconstrued. By itself, due professional care does not reduce audit risk to an appropriately low level. Due professional care is a responsibility exercised throughout the audit, similar to professional skepticism and judgment, and need not be repeated throughout the Board's standards. We recommend the sentence be rephrased to state that reasonable assurance is achieved by obtaining sufficient appropriate audit evidence.

3. Does the new proposed standard on audit risk describe clearly the relationship between detection risk and substantive procedures?
   We agree that the acceptable level of detection risk bears an inverse relationship to the risk of material misstatement and, at the assertion level, detection risk is reduced by performing effective substantive procedures. However, because the risk of material misstatement also consists of inherent risk and control risk, we believe the proposed standard would be clearer if it acknowledged that the acceptable level of detection risk is determined based on the auditor's assessment of these risks.

Appendix 2 - Audit Planning and Supervision

The following includes our responses to the Board's specific questions.

4. Are the proposed requirements for multi-location engagements appropriately aligned with Auditing Standard No. 5?
   We believe the proposed requirements for multi-location engagements are appropriately aligned with Auditing Standard No. 5.

5. Is it clear how the proposed requirements for multi-location engagements would be applied in audits of financial statements only?
   We believe the proposed standard is clear with regard to how the requirements for multi-location engagements would be applied in a financial statement only audit.

   Because Appendix 10 references ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*, in explaining the differences with the ISAs, we suggest that the Board clearly state that the multi-location provisions do not apply to "locations" audited by another auditor. Otherwise, the new multi-location provisions, including those in the proposed standard *Consideration of Materiality in Planning and Performing an Audit*, may be confusing to some auditors, particularly those in foreign jurisdictions that apply the ISAs. Under the Board's standards, the auditor's use of the work of another auditor is addressed by AU sec. 543, *Part of Audit Performed by Other Independent Auditors,* which differs from ISA 600.

6. Are the differences between the responsibilities for supervision of engagement team members and oversight of specialists in accordance with AU sec. 336 appropriate in light of the auditor's responsibilities to opine with reasonable assurance on whether the financial statements are fairly presented, in all material respects, in conformity with the applicable financial reporting framework?

   We believe the differences between the responsibilities for supervision of engagement team members and oversight of specialists are appropriate. However, unless we misunderstand the Board's intent, the note in paragraph 16 does not seem necessary. This note essentially states that the term "specialized skill or knowledge" includes persons employed by the auditor, as well as those engaged by the auditor. Yet, we believe the other paragraphs in this section are clear as to their applicability to such persons, which makes the note redundant.

Appendix 3 - Consideration of Materiality in Planning and Performing an Audit

Paragraph 9 requires the auditor to "take into account" the nature, cause (if known), and "amount" of misstatements accumulated in prior audits in determining tolerable misstatement, and planning and performing audit procedures. We do not fully comprehend what the requirement means or how it is to be applied. Some firms, including ours, calculate tolerable misstatement, for the financial statements as a whole, as a percentage of materiality. Though, tolerable misstatement can be lowered for a particular account based on the characteristics of the account.

We believe the inclusion of this specific requirement, in conjunction with the lack of application guidance, will result in a high likelihood of misapplication. In our view, the requirement appears to dictate a particular methodology for calculating tolerable misstatement that considers the amount of expected errors. This may differ from other methodologies where inherent risk is deemed higher due to the amount of expected errors, thereby increasing audit effort without reducing tolerable misstatement.

If the Board intends to change practice with regard to the calculation of tolerable misstatement, such as the language seems to indicate, additional guidance is critical in understanding the requirement. However, we prefer that the Board continue to allow flexibility in how tolerable misstatement is determined, consistent with the ISA and the extant interim standard.

The following includes our responses to the Board's specific questions.

7. Are the provisions in the new proposed standard regarding consideration of materiality in multi-location engagements appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?

   We believe the provisions regarding the consideration of "materiality" in multi-location engagements are generally appropriate. However, the description of "materiality level" in paragraph 10 is appropriately equivalent to the description of "tolerable misstatement" in paragraph 8. Accordingly, it would seem more appropriate to use "tolerable misstatement," in paragraph 10 to describe the level of audit procedures to perform at particular locations or business units. Otherwise, the paragraph confuses the concepts of materiality and tolerable misstatement.

8. Are the revised provisions regarding reassessment of materiality appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?

   We agree with establishing a requirement to reassess materiality. In paragraph 11, however, we believe the Board should consider removing item (b), as this item is basically a subset of item (a). We also believe that the "significance" of the matters that would require reassessment should be enhanced. For example, we do not believe the intent of the requirement is to force a routine reassessment, as it is likely that the financial statement amounts (the size) of any company will be different at year end versus the interim date when planning occurred. Rather, we believe the intent is to remind auditors of the need to reassess materiality when the relative size of the company changes substantially, and had the auditor been aware of this change when the audit was planned, a different level of materiality would have been established.

Appendix 4 - Identifying and Assessing Risks of Material Misstatement

The following includes our responses to the Board's specific questions.

9. Does the new proposed standard adequately describe the auditor's responsibilities for performing risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of risks of material misstatement due to error or fraud and to design further audit procedures?

   Generally, we believe the proposed standard adequately describes the auditor's responsibilities for performing risk assessment procedures. However, in addition to the comments in the CAQ letter, we believe the following matters need to be clarified:

   - The auditor's responsibilities for disclosures in paragraph 13. The requirement for the auditor to "identify the necessary disclosures" in order to identify and assess the risks of material misstatement related to omitted or incomplete disclosures seems to overlap management's responsibilities. The auditor should be required to understand the disclosures that are to be expected in the financial statements based on the auditor's understanding of the entity and its environment, rather than "identify" them.

   - The intent of the requirement in the note to paragraph 56(c). Risks at the financial statement level can affect many assertions because such risks are pervasive to the financial statements as a whole. Generally, risks at the financial statement level increase the risk of material misstatement at the assertion level, but cannot be associated with a particular assertion. As such, the auditor responds to risks at the financial statement level with an overall response. We believe this requirement inappropriately infers that the auditor should, and can, associate the risks at the financial statement level with particular assertions in order to assess risks at the assertion level. We believe this is a significant and unnecessary difference from the ISA that is not highlighted as such.

   - The Board's views in Appendix 10 as to the sufficiency of risk assessment procedures. As currently drafted, Appendix 10 seems to infer that the risk assessment procedures in the ISA are insufficient in comparison to PCAOB standards (page A10-9). Although additional risk assessment procedures are necessary for issuers, we fail to see the difference between the highlighted requirements. We have the same observations with regard to the required understanding of internal control (page A10-10) and the auditor's responses to risks (page A10-18). In this regard, we suggest the Board specifically describe the areas in which performance is expected to differ.

10. Are the auditor's responsibilities regarding the additional procedures for understanding the company and its environment in paragraph 11 clear?
    We have no comments other than those expressed by the CAQ.

11. Are the proposed requirements regarding obtaining an understanding of internal control over financial reporting appropriate in light of the auditor's responsibilities for identifying and assessing the risks of material misstatement?
    Overall, we believe the proposed requirements regarding obtaining an understanding of internal control over financial reporting are appropriate. The CAQ letter provides several comments to enhance the proposal. We reiterate the CAQ comment related to the requirement in paragraph 33 for the auditor to obtain an understanding of control activities. The Board should include additional guidance, similar to that contained in the ISA, to clarify the extent of the auditor's understanding.

12. Are the proposed requirements regarding the discussion among engagement team members about risks of material misstatement appropriate given the auditor's responsibilities for identifying and assessing the risks of material misstatement?
    We believe the proposed requirements regarding the discussion among the engagement team members about risks of material misstatement are appropriate, including the required discussion in paragraph 49 (and the related evaluation in paragraph 68) about how fraud might be perpetrated or concealed by omitting or presenting incomplete disclosures. We suggest, however, that the Board include application guidance that describes such fraud risks in more detail, particularly, how the omission of disclosures, or presenting incomplete disclosures, could be intentional to perpetrate or conceal fraud and deceive financial statement users.

Appendix 5 - The Auditor's Responses to the Risks of Material Misstatement

With respect to Appendix 10 as it relates to Appendix 5, we have the following observations:

- We believe that the highlighted difference with the ISA regarding the performance of substantive procedures (page A10-22) is misleading. ISA 300, *The Auditor's Responses to Assessed Risks*, requires the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement. This is the ISA requirement that should be included in Appendix 10 as a comparison to the PCAOB's requirement to perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.

- We believe that the highlighted difference with the proposed SASs relating to the consideration of confirmations (page A10-23) is incorrect. We bring to the Board's attention that the proposed SASs also include, similar to the ISAs, a requirement to consider whether external confirmation procedures are to be performed as substantive audit procedures. This is a conforming amendment in the proposed SAS, *External Confirmations.*

The following includes our responses to the Board's specific questions.

13. Are the proposed requirements for overall responses and responses involving the nature, timing, and extent of audit procedures appropriate given the auditor's responsibility to opine with reasonable assurance about whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?
    We believe the proposed requirements for overall responses and responses involving the nature, timing, and extent of audit procedures are appropriate.

14. Does the new proposed standard clearly describe when tests of controls are necessary in an audit of financial statements only?
    For the most part, the proposed standard clearly describes when tests of controls are necessary in an audit of financial statements only. We suggest, however, the Board clarify paragraphs 29 and 30 by referencing paragraph 16, which requires tests of controls during the period of reliance. The language in paragraphs 29 and 30 is similar to the requirements of an internal control audit, when the auditor obtains evidence about the operating effectiveness of controls to the "as of" date. In a financial statement only audit, we believe a reference to paragraph 16 would clarify that the auditor would only consider what additional evidence is necessary concerning the operation of controls when the auditor plans to rely on controls for the remaining period.

Appendix 6 - Evaluating Audit Results

The following includes our responses to the Board's specific questions.

15. Does the new proposed standard clearly describe the auditor's responsibilities for accumulating and evaluating misstatements?
    We believe the proposed standard clearly describes the auditor's responsibilities for accumulating and evaluating misstatements, except for paragraph 19. This paragraph seems misplaced as the auditor should consider individual misstatements and their effect on the assessed risk of material misstatement at the time they are identified to determine whether additional procedures are necessary. The requirement in this paragraph seems to place an unnecessary and burdensome documentation requirement on the auditor after the misstatements are accumulated. This is unnecessary because the auditor is required to document changes in risk assessments in response to audit findings.

16. Does the new proposed standard appropriately describe the auditor's responsibilities for evaluating the presentation of the financial statements, including evaluating bias, in light of the auditor's responsibility to opine with reasonable assurance on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?
    We believe the proposed standard appropriately describes the auditor's responsibilities for evaluating the presentation of the financial statements, including evaluating bias.

Appendix 7 - Audit Evidence

The following includes our response to the Board's specific question.

17. Does the new proposed standard describe clearly how the auditor should determine the financial statement assertions to use for both integrated audits and audits of financial statements only?
    Generally, we believe the proposed standard clearly describes the typical financial statement assertions, which are consistent with Auditing Standard No. 5. However, paragraph 12 differs from the guidance in the ISA and implies the use of "different" assertions. Although we understand the intent of paragraph 12, based on our understanding of the ISAs, we suggest the Board instead state that the auditor may express the assertions differently.

Proposed Amendments to PCAOB Standards

The proposed amendments to AU section 316, *Consideration of Fraud in a Financial Statement Audit*, are extensive. For future releases, we request the Board to consider the nature and extent of the revisions in determining whether it is necessary to release a new proposed standard or to fully illustrate the revisions in a marked document. We believe this would enhance the transparency of the amendments, as well as a respondent's ability to provide meaningful comments.

The following includes our response to the Board's specific question.

18. Are there provisions in the to-be-superseded standards that should be retained?
    We do not believe there are any provisions in the to-be-superseded standards that should be retained.

We would be pleased to discuss our comments and recommendations with you. If you have any questions, please contact Karin A. French, National Managing Partner of Professional Standards, at (312) 602-9160.

Sincerely,

Grant Thornton LLP

INSTITUT DER WIRTSCHAFTSPRÜFER

Institut der Wirtschaftsprüfer
in Deutschland e. V.

Wirtschaftsprüferhaus
Tersteegenstraße 14
40474 Düsseldorf
Postfach 32 05 80
40420 Düsseldorf

TELEFONZENTRALE:
+49 (0)211 / 45 61 - 0

FAX GESCHÄFTSLEITUNG:
+49 (0)211 / 454 10 97

INTERNET:
www.idw.de

E-MAIL:
info@idw.de

BANKVERBINDUNG:
Deutsche Bank AG Düsseldorf
BLZ 300 700 10
Kto.-Nr. 7480 213

Mr. Martin F. Baumann
Associate Chief Auditor
Public Company Accounting Oversight Board
c/o Office of the Secretary
1666 K Street, N.W.
Washington, D.C. 20006-2803
USA

By E-mail: comments@pcaob.org

March 2, 2010

Dear Mr. Baumann,

Re.: PCAOB Rulemaking Docket Matter No. 026
PCAOB Release No. 2009-007, December 17, 2009
Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk
And Related Amendments to PCAOB Standards

We would like to thank you for the renewed opportunity to comment on the PCAOB's Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk And Related Amendments to PCAOB Standards (hereinafter collectively referred to as the "proposed standards"). We are commenting for the second time on these proposed standards because they are directly relevant to the members of the German Wirtschaftsprüfer profession that audit the financial statements of SEC-registrants or their subsidiaries, and because PCAOB standards do influence standards setting elsewhere, including that of the International Auditing and Assurance Standards Board (IAASB).

As we had previously commented in our letter dated February 18, 2009, we welcome the updating of the PCAOB's interim standards that deal with audit risk and introduce the "risk assessment" and "risk response" paradigm currently effective in the International Standards on Auditing (ISAs), and many other national standards, and particularly welcome the efforts made to align the proposed standards with the ISAs as a measure towards the international convergence of auditing standards needed for international capital markets. However,

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we were disappointed that, in re-exposing these standards the Board had not made more effort to minimize differences between its standards and the ISAs wherever possible, given the comments we had made in our afore-mentioned letter. For example, the statement in the second paragraph on page A9-6, that “the organization and style of the new proposed standards … will provide a template generally to be followed in the future standards issued by the Board”, does not follow the IAASB’s example in terms of placement structure and wording of requirements. We also refer to our previous comment letter wherein we had discussed this issue in more detail.

In the enclosed Appendix to this comment letter, we have again addressed a number of what, in our view, are the more important differences between the proposed standards and the ISAs that have come to our attention through the review of the proposed standards, that remain unaddressed; commented on certain changes made that we view as problematical; and, where appropriate, responded to the questions posed by the Board.

If you have any further questions about our comments, we would be pleased to discuss them with you.

Yours very truly,

Klaus-Peter Feld
Executive Director

Wolfgang Böhm
Director International Affairs

494/584

Appendix

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APPENDIX

Q.1 Are the objectives in the new proposed standards useful in providing context for the requirements in the standards?

Subject to our comments below relating to the objectives in the individual standards, we agree that introducing objectives is useful.

Proposed Auditing Standard – Audit Risk in an Audit of Financial Statements

Q.2 Does the new proposed standard on audit risk describe clearly the concept of audit risk and its components?

No. We note that the Board has sought to improve the material explaining risk of material misstatement and audit risk, and in this context, support the addition of text in paragraph 6 mirroring part of the material in ISA 315.A105, as this will help auditors to better understand the nature of risks of material misstatement that may exist at the financial statement level. However, we are concerned that in citing three very different specific examples without further explanation may not be helpful; particularly as to the relationship between business risks and audit risk is likely to confuse readers of the standard, which may increase the expectations gap. ISA 315.A30, A31 and A33 do provide further explanation of the relationship between these risks. We believe that the standard needs to provide further explanation of this complex issue.

Q.3 Does the new proposed standard on audit risk describe clearly the relationship between detection risk and substantive procedures?

We do not provide comments on this matter.

Proposed Auditing Standard – Audit Planning and Supervision

Matters not covered by the questions posed

As we had commented previously, many of the issues addressed in paragraph 7 may be better placed in the risk assessment standard (as in the ISAs), rather than as part of the planning, since these matters relate to the obtaining of an understanding of the business aspect of risk assessment.

Paragraph 10 requires the auditor to develop and document an audit plan, specifying certain content. We would like to point out that in practice, and as is recognized in the ISAs, planning is an iterative process. It is not entirely clear to us whether this standard recognizes the practicalities of this, although the use of the term "develop" together with the clarification in paragraph 5 does seem to indicate this intention. It would be helpful if the PCAOB would clarify, within the standard, that as long as the matters listed in paragraph 10 are documented, it is not necessary that they be recorded within one document or that they are in the form of a single plan. For example, requiring an auditor to subsequently document a "plan" to reflect procedures performed for the sole purpose of ensuring that PCAOB inspectors will have a neat plan to review would be ineffective from both a cost perspective and an audit quality perspective – rather a running planning memo or similar could be developed during the course of the audit and as the audit progresses.

Q.4 Are the proposed requirements for multi-location engagements appropriately aligned with Auditing Standard No. 5?

We do not provide comments on this matter.

Q.5 Is it clear how the proposed requirements for multi-location engagements would be applied in audits of financial statements only?

In considering the risk of material misstatement associated with a location or business unit, sections c. and d. of paragraph 11 introduce the concept of <u>reasonable possibility</u> of material misstatement to a company's consolidated financial statements, cross referencing this term to FASB's use in relation to contingencies: Our views on the definition of "reasonable possibility" and its relationship to the FASB's use of the term in relation to contingencies (see the IDW comment letter of February 26, 2007) and the technical difficulties resulting from such use have been made known to you. These sections of paragraph 11 would be more appropriately placed in the standards on risk assessment, since this is to what these sections refer.

Q.6 Are the differences between the responsibilities for supervision of engagement team members and oversight of specialists in accordance with AU sec. 336 appropriate in light of the auditor's responsibilities to opine with reasonable assurance on whether the financial statements are fairly presented, in

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all material respects, in conformity with the applicable financial reporting framework?

The section entitled persons with specialized skill or knowledge has been significantly improved compared to the previous draft. However, the wording of paragraph 16 ought to be reworded so as to clarify that whilst a person with specialized skill or knowledge may assist the auditor, such a person does not relieve the auditor of the performance of appropriate risk assessments, application of planned audit procedures and evaluation of audit results respectively referred to in that paragraph. In this context, we refer to ISA 620.A4 which refers to the possibility that an auditor's expert may be needed to assist the auditor.

We agree that there needs to be a differentiation between experts in accounting or auditing (paragraph 18) and in other fields (paragraph 19); however, the differentiation should not solely rest upon whether they are experts in accounting and auditing or, when not, are part of the team or are engaged by the auditor, but should concentrate on whether they are performing audit work as opposed to providing solely expert services that assist the auditor in performing the audit. For example, an expert in a field other than accounting and auditing who although engaged by the auditor - but not part of the engagement team and not being an employee of the auditor's firm - nevertheless is hired to perform audit procedures that involve audit decisions, etc., should be supervised in the same manner as all audit team members. Therefore, without having thoroughly reviewed AU sec. 336 (which we note is, in any case, to be the subject of revision in the near future) we do not express an opinion on the adequacy or otherwise of the reference thereto in paragraph 19.

Proposed Auditing Standard – Consideration of Materiality in Planning and Performing an Audit

Matters not covered by the questions posed

We believe that the replacement of paragraph 2 with an explanation of the court's interpretation of federal securities laws is an improvement, as this can guide the auditor in considering how materiality required by the financial reporting framework should be interpreted. However, as we had also previously suggested, the proposed standard would greatly benefit from an explanation of what the PCAOB envisages the term "reasonable shareholder" to mean, similar to the material in ISA 320.04, which forms the basis for an auditor's consideration of materiality and does not appear to be inconsistent with the concept of a reasonable investor under U.S. securities law.

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We had previously noted that the proposed standard used the term "tolerable misstatement" from AU §350 *Audit Sampling* rather than the term "performance materiality" used in the ISAs. This has not been changed. Use of this term would be appropriate if "tolerable misstatement" as defined in AU §350 is the same as the meaning of tolerable misstatement in the proposed standard. However, we would like to point out that the two concepts are equivalent for a particular financial statement item only when sampling the entire population of items comprising that financial statement item (i.e., one could select particular items included in that financial statement item for testing and draw a statistical sample for testing on the remaining items). When sampling less than all of the population of items comprising a financial statement item, "tolerable misstatement" for statistical purposes for the sampled population (which would be a portion of the total population of the financial statement item) would be different than the "tolerable misstatement" applied to that entire financial statement item (which may or may not be the same as the "tolerable misstatement" for the financial statements as a whole) to reduce to an appropriately low level the risk that the aggregate of uncorrected and undetected misstatements in that item exceeds the materiality for that item (which may or may not be the same as the materiality for the financial statements as a whole). For these reasons, we again question whether it is appropriate to use the same terms for statistical sampling and for reducing to an appropriately low level the risk that the aggregate of uncorrected and undetected misstatements in an item exceeds materiality for that item.

The insertion of wording in the first sentence of paragraph 8 to now require the auditor determine tolerable misstatement for the purpose of assessing risks of material misstatement and planning and performing audit procedures *at the account or disclosure level* represents a significant change. This change also introduces a significant difference in an auditor's approach to performance materiality to that of the ISAs that will involve potentially considerably more work on the part of the auditor without necessarily adding much benefit. ISA 320.11 requires the auditor to "determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures". ISA 320.A12 provides a further explanation as to the nature and purpose of performance materiality as an audit tool and explains that performance materiality relates to the materiality level for financial statements as a whole and, where applicable, to the materiality level for a particular class of transactions, account balance or disclosure. An additional performance materiality at the account or disclosure level would only be necessary when the aggregation risks of risks of not detecting a misstatement are such that the level of performance materiality for the financial statements as a whole is not adequate for such account or disclosure (i.e., too high), or when an additional performance materiality is required because the particular account and disclosure requires its own materiality based upon users' needs.

In general, certain changes made are not particularly helpful. For example, the sentence added in paragraph 6 (previously paragraph 5) to the effect that establishing a materiality level for the financial statements as a whole "includes consideration of the company's earnings and other relevant factors" is, without any practical explanation of what such other relevant factors may be or of their interrelationship with earnings, not helpful. Also, in both the new notes following paragraph 7 and paragraph 11, it is not easy to understand how the "judgment" of a reasonable investor might be interpreted in the context of materiality for a particular account or disclosure given the explanation in paragraph 2 of the court's interpretation of materiality referring to a reasonable investor's perception relevant to the "total mix" of information made available in financial statements. Guidance as to what this judgment is meant to mean in practical terms is needed.

Q.7 Are the provisions in the new proposed standard regarding consideration of materiality in multi-location engagements appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?

The basic requirement appears in line with ISA 600, where materiality at a component (PCAOB term = location) is set by the group engagement partner. However, it is not clear that the auditor performing the work at/on that component's financial information is required to set a performance materiality (PCAOB term tolerable misstatement). The standard should clarify this.

Q.8 Are the revised provisions regarding reassessment of materiality appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?

These need to be amended to follow ISA 320.12, since a change in overall materiality may not necessarily affect the performance materiality (PCAOB term tolerable misstatement) depending on the reasons causing to set that level. For example, if materiality itself has to be revised downwards, but tolerable misstatement was already quite low to take account of detection risk, there may not be a case to amend tolerable misstatement further; in other cases it may need amending. Therefore the auditor should first be required to determine whether it is necessary to revise tolerable misstatement, and whether the nature, timing and extent of further audit procedures remain appropriate.

Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement

Matters not covered by the questions posed

We were disappointed to note that the definition of significant risk remains the same as that in the previous draft. In defining a significant risk for this standard as "a risk of material misstatement that requires special audit consideration" deviates from the definition used by the ISAs because the PCAOB definition does not clarify that only those risks that the auditor has identified and assessed as such can be given special audit consideration. In this context, we refer to our second comment on the Proposed Auditing Standard – The Auditor's Response to the Risks of Material Misstatement in our previous letter, which explained that by requiring an appropriate response to actual misstatement risks, rather than to those assessed, the PCAOB is setting a standard that is impossible to meet in practice or theory. We are pleased to note that the PCAOB has recognized and attempted to address this matter within the requirements of that particular standard, but were disappointed that this has not been rectified throughout the set of risk standards in a consistent manner. We suggest this definition be amended accordingly.

Paragraph 42 (previously 41) requires that, in identifying risks of material misstatement, the auditor should take into account information relevant to identifying risks obtained by the auditor through other engagements performed for the company. We are concerned to note that both concerns we had mentioned in our previous letter remain unaddressed, as the PCAOB believes that the suggested changes would weaken the standard. First the word "auditor" could mean the audit firm. It is unlikely that audit firms will be in a position to convey only relevant information from one team performing an unrelated non-assurance engagement at the company to another performing the audit without developing very costly reporting systems between engagement teams; there may even be confidentiality barriers. The ISAs resolve this problem by addressing the engagement partner only. Second, even if the engagement partner becomes privy to information from another completely unrelated engagement, it remains unclear to us how the relevance of this information to identifying risks of material misstatement would be established in this context. We had previously suggested that, similar to the requirement of ISA 315.08, the engagement partner need only consider whether it may be relevant at that stage. We again suggest that the proposed standard be aligned to the ISAs.

Paragraph 51 (previously 50) retains the requirement that auditors make inquiries of those within the company that "might reasonably be expected to have information…". This remains a very open-ended requirement that begs the question: reasonably expected by whom? The auditor? The PCAOB? The courts? We would like to reiterate that, in our view, this is unreasonable, because with hindsight any third party will always be able to claim that the auditor should have made an inquiry of someone that he hadn't. As described in ISA 315.06(a), it is the auditor's judgment that is paramount in this situation: no one else was there at the time and there shouldn't be any second-guessing with hindsight unless the auditor's judgment was clearly unreasonable in the circumstances. This has not been addressed in redrafting. In contrast, we note that the wording of the requirement in paragraph 54 has been amended in response to our previous comment on the same issue. This now requires the auditor "…to identify…by considering whether others…might have additional information or be able to corroborate…" Thus, it is the auditor's consideration as to what others might have (i.e., professional judgment) that is the deciding factor. We suggest this requirement in paragraph 51 be amended accordingly.

Certain changes made to this standard stem from the PCAOB's intent stated on page 6 of the release to enhance the requirements for evaluating disclosures, as a result of observations from its oversight activities. However, the Board has identified only two areas for singling out consideration of disclosures alone: First, by including in the discussion among key team members how fraud might be perpetrated or concealed by omitting or presenting incomplete disclosures in paragraph 49, and second, by requiring in paragraph 68 an evaluation of how fraud could be perpetrated or concealed through omitting or presenting incomplete disclosures. Assuming the PCAOB's aim is to strengthen audit work on disclosures, we wondered why both these passages do not also include reference to incorrect or inaccurate disclosures – as disclosure misstatement is not restricted to omission or partial omission but also ought to foresee that incorrect information may be presented within a disclosure.

Q.9 Does the new proposed standard adequately describe the auditor's responsibilities for performing risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of risks of material misstatement due to error or fraud and to design further audit procedures?

In our view, the addition of new explanatory text in paragraph 5 explaining some possible sources of risks of material misstatement, whilst helpful, needs to mention fraud as well, as the potential for fraud varies from entity to entity and is a major aspect that needs to be considered in risk identification and assessment.

As we had previously pointed out, the use of the words “should consider” in what is in the new draft paragraph 11 will have the effect of requiring the auditor to justify for each bullet point why a certain procedure was not performed, rather than having auditors take a top-down approach to determining which audit procedures they ought to be performing in the circumstances. This leads to a checklist approach to the issues identified, which is not conducive to audit quality.

Paragraph 39 (previously 38) of the proposed standard specifically requires the auditor to incorporate knowledge obtained in past audits in the risk assessment of subsequent audits. Whilst we agree that information from past audits should not be ignored, as we had previously commented, the real issue for auditors is whether this information is still relevant. We suggest that the PCAOB follow the ISAs (see ISA 315.09) in being more cautious in this regard, and consider aligning this requirement with that of ISA 315.09.

The use of the phrase “analytical procedures designed to” in paragraph 43 (previously 42) suggests that such analytical procedures are more effective than they actually are in covering items (a) and (b). As pointed out in the ISAs (ISA 315.6(b) together with ISA 315.A7), analytical procedures contribute to an auditor’s understanding of (a) and (b), but only in conjunction with other procedures.

Q.10 Are the auditor's responsibilities regarding the additional procedures for understanding the company and its environment in paragraph 11 clear?

The examples given in paragraph 11 are useful; however the first bullet point in the requirement could be interpreted more broadly than we believe reasonable. Given the myriad of information that may be available to the public on the internet it would be useful to clarify that the requirement does not mean that the auditor would be expected to read each and every mention of the company made public (e.g., it would not include comments by individuals on networking sites or blogs, etc., critical of the company’s products or business practices, etc., or even all of a company’s website, which may be extensive and subject to continual change).

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Q.11 Are the proposed requirements regarding obtaining an understanding of internal control over financial reporting appropriate in light of the auditor's responsibilities for identifying and assessing the risks of material misstatement?

As we had previously pointed out, paragraph 18 (previously 20) states that the auditor should obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement and (c) design further audit procedures. We still have a number of difficulties with this requirement. First, we would like to point out that, unless the auditor does a combined inherent risk and control risk assessment (a misstatement risk assessment), an auditor identifies types of potential misstatements by examining inherent risks without including the effect of control risk. This is in fact required by the ISA 315.26 for significant risks. Second, some components of internal control only affect the misstatement risk at the financial statement, rather than assertion level. Consequently, obtaining an understanding of these components will not lead to the ability to identify types of potential misstatements, which is an assertion-level concept. Third, the only factors that affect the risks of material misstatement are inherent and control risk: does this mean that by requiring an assessment of the factors that affect the risks of material misstatement, the PCAOB is requiring a separate, rather than a combined risk assessment for all cases, including risks that are not significant risks? This seems to be at odds with other requirements in the standards. Furthermore, what is left (sufficient understanding of internal control to design further audit procedures) is now covered by the objective of the standard, since we note that the objective used in ISA 315.03 has now been applied. It is therefore redundant. On the whole, therefore, there is no need for this requirement, which only confuses a number of issues and therefore causes more harm than good.

Q.12 Are the proposed requirements regarding the discussion among engagement team members about risks of material misstatement appropriate given the auditor's responsibilities for identifying and assessing the risks of material misstatement?

It still seems to us that the requirement in paragraph 47 (previously 46) provides a gratuitous definition of who “key engagement members” are without adding any real guidance because it interprets the word “key” by using the term “significant engagement responsibilities”, which is not particularly helpful. Furthermore, one would presume that the discussion would cover only important matters, which makes the following requirement to communicate important matters to the other engagement team members too restrictive. On the other hand, it begs the question of "important to whom"? The solution in ISA 315.10.02 is more practical in that the engagement partner makes the determination of what needs to be reported to whom on a "need to know" basis.

We had also commented that paragraph 49 (previously 48) represents a rules-based approach to audits by including a "checklist" of matters that should be covered in the discussion among team members about potential misstatements due to fraud. Whilst we agree that the addition of a discussion as to the susceptibility of the financial statements to a material misstatement through related party transactions mirrors ISA 550.11, it would also need to refer to relationships as well as transactions given the potential not to disclose such relationships irrespective of whether there had been any transactions or not. We continue to believe that not all of these matters may be relevant to all audits, and there may be matters that are relevant that are not on the list (see ISA 240.A11). We had therefore suggested that the PCAOB consider whether guidance on this matter may be more helpful than a list of requirements and repeat this suggestion.

Paragraph 50 (previously 49) requires specific communication of items that are required of auditors on all audits. We continue to view this as a rather strange and even redundant requirement. Once having communicated these matters to all audit staff at a firm, why would they need to be communicated again on every engagement? This is a matter that ought to be addressed as part of the fraud standard in terms of the overall stance taken by team members on all audits, not as part of risk assessment for each audit.

Proposed Auditing Standard – The Auditor's Response to the Risks of Material Misstatement

Q.13 Are the proposed requirements for overall responses and responses involving the nature, timing, and extent of audit procedures appropriate given the auditor's responsibility to opine with reasonable assurance about whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?

We are pleased to note that the requirements section has been changed along the lines we had suggested in our previous letter, such that the requirements now relate to the <u>assessed</u> risks of material misstatement responses rather than to the risks of material misstatement, as was the case in the PCAOB's previous draft. However, we do not agree with the Board that neither the wording of the objective nor of the title of the standard should have been amended to reflect

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this change. The proposed Standard "Identifying and Assessing Risks of Material Misstatement" is the correct place to address this issue, as the overall objective of an audit can only be achieved using a risk-based approach, if the audit risks are firstly identified and then subsequently appropriately assessed. An auditor can only respond to the risks of which he or she is aware and for which he or she has made an appropriate assessment. Unless the objective is amended to be in line with the requirements of the standard, no auditor complying with the requirements of this standard will be in a position to fulfill its objective. This is not an appropriate method for standard setting. We therefore suggest the objective and title be amended accordingly, as we had previously proposed, in line with the very precisely worded objective used in ISA 330.03.

We continue to believe that it is important for auditors to implement overall responses to risks at the financial statement level because these risks are pervasive to the financial statements and also that they would be difficult to address only at the assertion level. For this reason, we do not share the view of the PCAOB that an auditor need not match overall responses to misstatement risks at the financial statement level. Such a requirement does not lead to the auditor being able to avoid performing audit procedures to address risks of material misstatement at the assertion level at all and therefore such a requirement ought to be included in the proposed standard. We suggest the wording of paragraph 5 be amended accordingly.

We do not understand why the requirement of paragraph 19, to test design effectiveness, is included in this standard, when it is already covered in the standard on risk assessment. We note that on page A4-10, paragraph no. 20 requires an evaluation of the design of controls. This potential double counting begs the question whether the Board intends the testing design effectiveness in this standard to be different from the afore-mentioned evaluation, and, if so, in what way?

Q.14 Does the new proposed standard clearly describe when tests of controls are necessary in an audit of financial statements only?

We note that certain changes have been made to paragraphs 30 and 31, but do not understand why they were not based more on the relevant ISAs, for example, we would have expected the control environment to have been added within paragraph 30 (from ISA 330.A 233).

One particular more stringent requirement is that in the previous draft paragraph 37 stated: "For audits of financial statements, the auditor should obtain evidence about the design and operating effectiveness of *controls selected for testing in the current year audit*" [italics added for emphasis]. This has been changed such that the new draft paragraph 31 reads: "For audits of financial statements, the auditor should obtain evidence during the current year audit about the design and operating effectiveness of *controls upon which the auditor relies*." This is far more onerous and does not follow the equivalent ISA, as ISA 330. A 35 states

> "In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor performs audit procedures to establish its continuing relevance ", and further in A37: "The auditor's decision on whether to rely on audit evidence obtained in previous audits for controls that:
>
> (a) have not changed since they were last tested; and
>
> (b) are not controls that mitigate a significant risk,
>
> is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment, but is required by paragraph 14 (b) to be at least once in every third year."

We note that Page A9 – 48 states "One commenter expressed a concern that eliminating the auditor's ability to use rotational testing of controls in audits of issuers differs from the ISAs and would be a significant, unnecessary change from current practice. The Board continues to believe that auditors should support their control risk assessments each year with current evidence. When the auditor has tested controls in past audits, the new proposed standard allows the auditor significant flexibility to adjust the amount of evidence needed based on the relevant factors." However, other than footnote no. 12 which permits the auditor to use a benchmarking strategy solely for automated application controls, there is no guidance either in the proposed standard or the additional discussion as to what this purported "flexibility" might mean in practice. Yet other than stating its belief that auditors should support their control risk assessments each year with current evidence, the Board does not give any reasons for this requirement being more stringent than that of ISA 330.

We remain concerned with the requirement for substantive tests of details for all relevant assertions for significant accounts or disclosures. We do not agree with the changes made to the text of paragraph 37 (formerly 41): "As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases". We would like to point out that in some cases performing substantive tests of details rather than, or in addition to, tests of control and analytical review procedures may not obtain any additional assurance because the tests of detail may not be relevant. For example, for some cases, as identified in ISA 315.29, for risks for which substantive procedures alone do not provide sufficient appropriate audit evidence (e.g., the completeness assertion or some fraud risks), substantive tests of details may be irrelevant. For this reason, we believe that the requirement to perform such substantive tests of detail for all relevant assertions, as described in paragraph 36 of the proposed standards, is inappropriate and needs to be deleted.

The requirement in paragraph 45 (previously 49) to compare relevant information about the account balance at the interim date with comparable information at the period end presumes that there will always be comparable information. In our view, requirements should not be introduced for situations that may or may not exist on most audits, unless there is an overriding need for a requirement predicated upon such existence, even if it is rare. We do not see such an overriding need when auditors are already required to test the remaining period.

Proposed Auditing Standard – Evaluating Audit Results

Matters not covered by the questions posed

Appendix B is new. This should be useful, but we wonder why it was not more closely aligned with ISA 330. A16; in particular the last items therein.

Q.15 Does the new proposed standard clearly describe the auditor's responsibilities for accumulating and evaluating misstatements?

The new explanation of how the term “clearly trivial” is meant to be applied in practice (second sentence of paragraph 11) is somewhat confusing and in any case, in our view, not needed. This explanation infers that the clearly trivial threshold plays substantially the same role as that of tolerable misstatement. The footnote to paragraph 10 is easier to understand and, subject to the comment in the next paragraph, in our view sufficient. We suggest the second sentence of paragraph 11 be deleted.

Paragraph 20 requires the auditor evaluate whether identified misstatements might be indicative of fraud, irrespective of considerations, e.g., as to their magnitude. In our opinion, it ought to be made clear that where there is such indication, depending on the magnitude of the fraud the auditor uncovers some misstatements that had originally been classified as clearly trivial, which in complying with the requirements of paragraph 10 may need to be reclassified and

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therefore added to the auditor's documentation of accumulated misstatements required by that paragraph.

Q.16 Does the new proposed standard appropriately describe the auditor's responsibilities for evaluating the presentation of the financial statements, including evaluating bias, in light of the auditor's responsibility to opine with reasonable assurance on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?

We agree that the situation depicted in paragraph 25b. is a reasonable example to include however, in our opinion, the term "identified misstatements other than those that are not clearly trivial" ought to be used, as management bias is not fraud, rather its main relevance is to the materiality in misstatement of the financial statements. A lower threshold would result in more audit work not reflected in an increase in audit quality.

Proposed Auditing Standard – Audit Evidence

Q.17 Does the new proposed standard describe clearly how the auditor should determine the financial statement assertions to use for both integrated audits and audits of financial statements only?

We do not provide comments on this matter.

Proposed Amendments to PCAOB Standards

Q.18 Are there provisions in the to-be-superseded standards that should be retained?

Without fully considering the entire text of each of these standards we do not provide comments on this matter with the exception of the following.

As we noted in our previous comment letter, the PCAOB has proposed certain changes to its standard AS-3 "Audit Documentation" despite the fact that only two of seven respondents to the question in PCAOB Release 2008-006 concerning the adequacy of documentation requirements supported adding specific documentation requirements whereas four respondents indicated that the existing requirements were adequate.

Indeed, the proposed amendments to AS-3 “Audit Documentation” represent, in the main, an additional degree of precision being added to the current requirements of that standard, which, as stated on page A9-65, could help reviewers understand the areas of greater risk and the auditor’s responses to those risks. Thus, they appear to us to stem more from the results of inspections than from comments from respondents to the previous proposed standards.

We are concerned that the degree of detail may be overly prescriptive, and refer to our letter to the PCAOB dated January 19, 2004, in which we had cautioned on the possible detrimental effects of overly prescriptive requirements.

Subject: PCAOB Docket 026: Comment

Docket 026: Re-Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk; Proposed Conforming Amendments to PCAOB Standards

Comment: William Kinney, Professor, University of Texas at Austin

I appreciate the opportunity to comment on three specific aspects of Appendix 3 regarding "Consideration of Materiality in Planning and Performing an Audit" that I believe are not in the public interest.

Paragraphs 2: To guide the auditor in determining materiality for the financial statements as a whole, the proposal's only source is a 1976 U.S. Supreme Court decision that defines when "a fact" is material (rather than defining the *amount* of misstatement that would cause the financial statements as a whole to be materially misstated). The 1976 decision acknowledges that determining a material amount requires "delicate assessments of the inferences a 'reasonable shareholder' would draw," but neither the Court nor the proposal provides guidance or criteria for how such "delicate assessments" should be made.

Adoption of this paragraph would replace the lengthy history of development of the concept of a material amount in professional accounting and auditing standards (as well as numerous other court decisions) with a *single* court decision made under case-specific circumstances more than a quarter of a century ago and under vastly different circumstances and technologies.

If the Board wishes to make such a change, then it seems to me that the Board should provide guidance as to how the single definition would be applied in 2010 and beyond. Frankly, I'm skeptical of the viability of such a path. I base this judgment, in part, on stock price analyses related to the SEC's SAB 99 materiality criteria reported in a 2002 *Journal of Accounting Research* article by Kinney, Burgstahler, and Martin.

Paragraph 10: This paragraph states that "materiality at an individual location cannot exceed, *and generally should be less than*, materiality for the financial statements as a whole" (emphasis added). This guidance may be correct, but under what conditions is it acceptable for an auditor to audit Subsidiary A, Subsidiary B, . . ., Subsidiary Z to the same materiality amount, say $100,000, and yet conclude that the Consolidated statements are free of misstatements of no more than $100,000? If the Board has valid exceptions in mind, then list them or describe their contexts so that auditors will reduce the extent of auditing *only* when the Board exceptions are met. If there are no known exceptions, then "generally" should be deleted.

Paragraphs 11 and 12: I may have misinterpreted paragraph 11, but it seems to suggest the following example: "Suppose that the auditor plans the audit in September based on expected net income for the calendar year of $1,000,000 and determines that planning materiality is, say 5% of $1,000,000 or $50,000. At the December year end, the auditor finds that net income for the year is $1,000." My reading of paragraph 11 is that the auditor is obligated to reduce planning materiality – perhaps to $50 – and to greatly modify the auditing procedures necessary to obtain sufficient audit evidence per paragraph 12?

Does the proposal presume that a "reasonable investor" would expect that the auditor would change planning materiality to $50? I hope not and believe that such an obligation would not be in the interests of the "reasonable shareholder" or the public interest.

KPMG LLP
757 Third Avenue
New York, NY 10017

Telephone 212-909-5600
Fax 212-909-5699
Internet www.us.kpmg.com

March 2, 2010

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C., 20006-2803

PCAOB Rulemaking Docket Matter No. 026
Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Related Amendments to PCAOB Standards

Dear Mr. Secretary:

KPMG appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2009-007, "*Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Related Amendments to PCAOB Standards*," that includes the following proposed auditing standards as appendices (collectively, the Proposals):

- *Audit Risk*
- *Audit Planning and Supervision*
- *Consideration of Materiality in Planning and Performing an Audit*
- *Identifying and Assessing Risks of Material Misstatement*
- *The Auditor's Responses to the Risks of Material Misstatement*
- *Evaluating Audit Results*
- *Audit Evidence*

Effective identification and assessment of, and response to, risks are fundamental to the conduct of high quality audits. Further, global consistency in auditing standards and auditor execution relative to risk assessments and responses are important to furthering the objective of enhancing audit quality around the world. As noted in our previous comment letter on the PCAOB's October 2008 "*Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Conforming Amendments to PCAOB Standards*," we support the Board's efforts to update its risk standards and believe that the final standards will improve auditor performance and enhance consistent execution in areas that are fundamental to the conduct of an audit.

This letter is organized by first providing general observations and comments on the Proposals as a whole, followed by comments on specific issues in an Attachment. Our general observations discussed below are organized based on the following:

- Improvements to the Proposals and the Standards Setting Process
- Convergence of Auditing Standards
- Codification of the Board's Standards
- Release Text
- Public Involvement in the Standards Setting Process

Improvements to the Proposals and the Standards Setting Process

We recognize the significant effort of the PCAOB and its staff in development of the Proposals and commend the PCAOB for re-exposing the Proposals for public comment. Additionally, we appreciate the Board's consideration and responsiveness to the feedback from comments received on its original proposal and believe that the proposed standards are significantly improved in a number of areas. For example, we believe the Proposals are better integrated and aligned with the principles from PCAOB's Auditing Standard No. 5, *An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements* (AS No. 5). In addition, we believe the Proposals are significantly improved not only with respect to their organization but also in the clarity of the underlying requirements.

Further, we recognize and appreciate the Board's efforts to provide its perspectives on the differences between its proposed standards and those of the International Auditing and Assurance Standards Board (IAASB) and the AICPA's Auditing Standards Board (ASB). Comparisons with these standards, combined with the Board's rationale for any differences, provide useful insights into the Board's views and its intent for changes to audit practice. This perspective enhances the ability for interested parties to provide thoughtful comments in response to the Board's proposals, which in turn should enhance the Board's efforts to improve audit quality.

While we commend the PCAOB for these measures, we recommend that the Board consider further enhancements to its standards setting process that would provide additional transparency to the Board's rationale and expectations for changes to practice. We support the following remarks made by Acting Chairman Daniel L. Goelzer at the December 17, 2009 open meeting whereby he urged "the Board to continue to explore ways of making its standard setting – and the thinking that underlies its proposals – more open." Further enhancements could include emphasizing the expected significant changes to practice, which is consistent with Board member Charles D. Niemeier's suggestions at the December 17, 2009 open meeting that the

PCAOB, as part of the release of a proposed or final standard or rule, should more clearly express what they expect to change as a result of such standard or rule. We believe that providing specific descriptions of the Board's desired changes to current audit practice, along with explanations of expectations with regard to expected performance as a result of a proposal, final standard or rule, would provide for a clearer understanding of the changes desired from the relevant proposals or standards. The Financial Accounting Standards Board uses a similar approach to provide this type of information.

We believe that practices such as these would provide additional, helpful transparency to the Board's standards setting process, facilitate a better understanding of the Board's intended changes to practice, enhance the feedback received by the Board, and encourage more consistent implementation through enhanced clarity – all of which we believe contributes to advancing the Board's mission to improve audit quality.

Convergence of Auditing Standards

As stated in our previous comment letter, we fully support the Board's consideration of the work of other standard setters, such as the IAASB and ASB. While we recognize that the Board may decide that different procedures are appropriate in the U.S. public company audit context, we encourage the Board to continue to minimize the differences in its standards to only those matters that are unique to audits of issuers in the U.S.

As mentioned above, we recognize the Board's efforts to provide increased information regarding the Board's rationale for the differences that remain through the Board's responses to the comments received. We also recognize the improvements made to reduce differences between the PCAOB's standards and the International Standards on Auditing (ISAs). For example, we noted a number of areas in which the requirements in the Proposals were more closely aligned with the ISAs, including greater consistency with the terminology used by the IAASB. Additionally, we noted that in areas where differences in terminology remained, the Board provided rationale for maintaining the differences. We believe that minimizing differences in language, clearly articulating the rationale for any differences and explaining the expected auditor actions as a result of the differences is critical to enhance understanding of the standard by auditors. Such enhanced understanding will facilitate more consistent application of auditing standards, improve the effectiveness and efficiency of implementing new standards, and improve audit quality. For example, minimizing differences allows firms to cultivate synergies related to training, implementation, and the development and maintenance of quality control systems that accommodate the standards of the various standards setting bodies – all factors that we believe contribute to enhanced audit quality.

Codification of the Board's Standards

As noted in our previous comment letter, we acknowledge and support the Board's objective of using the Proposals as a foundation for its standards setting activities. However, the introduction of these standards into the Board's framework adds a significant layer of professional standards to existing interim standards and previously issued PCAOB auditing standards. In addition, given the PCAOB's recent commitment to an extensive standard setting agenda without a clear mechanism for updating existing standards in the future, we are concerned that new standards may become increasingly cumbersome for an auditor to understand and effectively apply in practice. We recommend that the PCAOB undertake a project to codify all PCAOB auditing standards (interim standards, AS No. 7 and earlier standards, these risk standards when finalized and any future standards when issued) to allow for greater understandability and more consistent application by auditors and thereby promote audit quality.

Release Text

We support the Board's efforts to increase the transparency of the standards setting process, including efforts to provide its perspective on the differences between its proposed standards and those of the IAASB and ASB, as well as its consideration of comments received. However, we are concerned that in some situations, it appears that in addition to providing insight into the Board's decision-making process, the Board is also interpreting aspects of the standard in the release. Interpreting standards through release text can result in potential confusion over the requirements within the related standard, inconsistent application by auditors, and may not be given the same consideration by auditors given that the release is not ultimately part of the final standard. As a result, we encourage the Board to provide such interpretive guidance within proposed standards as opposed to the accompanying release.

Public Involvement in the Standards Setting Process

In addition to our comments supporting the PCAOB's efforts to increase transparency in its standards setting process above, we encourage the Board to seek ways to increase the depth and accelerate the timing of public involvement, including the auditing profession, in its standards setting process. We encourage the PCAOB to consider whether field-testing certain proposed standards as part of the Board's overall standards setting process would provide it with an opportunity to gain insights as to whether the standards are fulfilling the Board's intended changes to auditor performance. We believe that such an addition to the process would enhance the efficiency and effectiveness of the standards setting process.

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Set forth in the Attachment to this letter are comments on specific matters included in the Appendices and conforming amendments to PCAOB Standards.

We appreciate the Board's careful consideration of the previous comments, and fully support the Board's efforts with regards to the re-exposed Proposals as well as the overall improvements to its standards setting process. If you have any questions regarding our comments or other information included in this letter, please do not hesitate to contact Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com or Glen L. Davison, (212) 909-5839, gdavison@kpmg.com.

Very truly yours,

KPMG LLP

cc: PCAOB Members and SEC Commissioners

PCAOB
Daniel L. Goelzer, Acting Chairman
Willis D. Gradison, Member
Steven B. Harris, Member
Charles D. Niemeier, Member
Martin Baumann, Chief Auditor and Director of Professional Standards

SEC
Mary L. Schapiro, Chairman
Luis A. Aguilar, Commissioner
Kathleen L. Casey, Commissioner
Troy A. Paredes, Commissioner
Elisse B. Walter, Commissioner
James Kroeker, Chief Accountant

KPMG

Comments on Proposed Standards

	Appendix 1: Audit Risk
1a	Paragraphs 9-10 – We note that the proposed standard could be improved by including certain language currently included in the PCAOB's interim standards related to the concept of detection risk (i.e. paragraph 81 of the PCAOB interim standard AU 319, *Consideration of Internal Control in a Financial Statement Audit*, which states "The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions.") We believe this language could serve to enhance the understanding of the audit risk model and would recommend that the PCAOB consider including it.

	Appendix 2: Audit Planning and Supervision
2a	Paragraph 7 – This paragraph states that the auditor should evaluate whether certain matters listed are important to a company's financial statements and ICFR and, if so, how they will affect the auditor's procedures. We are not clear how the auditor's actions to "evaluate whether" such matters, as currently drafted, would differ from the requirement in the Board's extant auditing standard (paragraph 3 of AU 311, *Planning and Supervision*) that the auditor "should consider" such matters. Therefore, we recommend the PCAOB consider modifying the language in paragraph 7 to replace "should evaluate" with "should consider" or alternatively, describe any intended difference in auditor performance and documentation requirements.
2b	Paragraphs 11-14 – These paragraphs outline the auditor's responsibilities with respect to multi-location engagements. However, the Board states in Appendix 10 that these provisions "are applicable to all multi-location audits, not just group audits." The Board's existing interim standard (AU 543, *Part of the Audit Performed by Other Independent Auditors)*, is the PCAOB's prevailing guidance with respect to referring to the work of another auditor. The multi-location requirements in paragraphs 11-14, as well as in other proposed standards, are not clear as to how they are to be applied when another auditor audits the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements. In addition we note that the Board's standards do not currently contain a definition of a "group audit," nor do the standards or the Board's release to the proposed standards contain any discussion of what the similarities and/or differences between multi-location audits and group audits might be. Therefore, we request the Board to clarify its intent

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	with respect to the application of these paragraphs (see further discussion in “Release Text” section on page 4 of this letter).
2c	Paragraph 14 – This paragraph appears to create a narrower or more prescriptive requirement than the requirement set forth in paragraph 5c of the proposed standard, *Auditor’s Responses to the Risks of Material Misstatement*, relating to introducing an element of unpredictability in the auditing procedures auditors perform at locations or business units from year to year. Paragraph 14 appears to require auditors to change the nature, timing and extent of audit procedures performed at various locations each year, whereas paragraph 5 requires that auditors incorporate unpredictability and provides varying the locations where procedures are performed as an example of how that might be achieved. We agree with the requirement for auditors to introduce an element of unpredictability in the audit plan. However, we do not believe it is necessary to dictate the specific manner in which the element of unpredictability is to be introduced. Given that the requirement in paragraph 5 is intended to impact the auditor’s overall response to the assessed risks of misstatement, including the risk of fraud, we recommend deleting paragraph 14 from this standard or including this paragraph as an example to paragraph 5 of the proposed standard *Auditor’s Responses to the Risks of Material Misstatement*.

	Appendix 3: Consideration of Materiality in Planning and Performing an Audit
3a	As in the original proposal, the proposed standard uses the term “tolerable misstatement” (e.g., paragraphs 8 and 9), which is different from the term “performance materiality” used in ISA 320 (Revised and Redrafted), *Materiality in Planning and Performing an Audit* for essentially the same concept. As described by the Board in Appendix 9 of the proposed standards, we recognize that the term is well understood by auditors and that the Board is not seeking to change the concept as described in existing PCAOB standards. However we note that currently, the term is defined and largely understood by auditors in the context of audit sampling (as defined in AU 350, *Audit Sampling*, in the PCAOB’s interim standards). Using the same term in two separate fashions – to both assist auditors in assessing risks of material misstatement for the purpose of determining an appropriate audit response and to plan a sample – could result in confusion for auditors and result in misapplication of the concepts, which in turn, could have adverse impacts on audit quality. Therefore, to avoid potential confusion, we recommend that the PCAOB replace the term “tolerable

KPMG

	misstatement" in the proposed standard with "performance materiality," which is the equivalent term used in the ISAs and in the ASB's analogous redrafted proposed standard.

	Appendix 4: Identifying and Assessing Risks of Material Misstatement
4a	Paragraph 3 – This standard contains requirements and guidance related to the procedures auditors should perform to identify and assess the risks of material misstatement. Additionally, a significant portion of this standard relates to risk assessment procedures auditors should perform to obtain an understanding of the entity and its environment in order for the auditor to provide himself/herself with a reasonable basis to assess those risks. However, we note that the objective excludes the concept that the identification and assessment of risks are obtained through the auditor's understanding of the company and its environment. As such, we recommend the objective be modified to recognize that the auditor's identification and assessment of risks is "through understanding of the entity and its environment." The addition of this language to the objective will help emphasize how the requirements articulated in the standard are intended to provide the auditor with the requisite understanding of the entity and its environment. Such a clarification would appear to be consistent with the PCAOB's proposed standard and would also be consistent with the objective of ISA 315, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*.
4b	Paragraph 11 – This paragraph contains procedures an auditor should consider performing as part of obtaining an understanding of the company. We agree that information from such procedures, in many instances, would provide the auditor with meaningful insights into the company and therefore, enhance the assessment of risks. However, we note that the broad nature of the procedures, combined with the presumptively mandatory requirement to consider performing the procedures, may result in auditors expending significant efforts to identify such information and/or documenting the considerations regarding the importance of such information to the auditor's understanding of the company (e.g. observing or reading transcripts of … other meetings with investors…). Such excess efforts may not result in a commensurate increase in audit quality. As such, we recommend the PCAOB consider amending the requirement to indicate that the auditor "might consider" the procedures outlined within the paragraph.
4c	Appendix A5 - The definition of significant risk should make clear that it is the *auditor* who makes a determination of the areas that are deemed significant risk and thus require special audit consideration based on the

KPMG

	auditor's assessment of the entity's risks. This concept is excluded from the definition as set forth in Appendix A. We believe the definition of significant risk would be enhanced by including the following language: *Significant risk* – A risk of material misstatement that *the auditor determines* requires special audit consideration.
4d	Paragraph 20 – With respect to control design effectiveness, the first note to paragraph 20 states that "Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness." However, the second note to this paragraph, which discusses evaluating whether a control has been implemented as designed, does not make the same statement as it relates to evaluating whether a control has been implemented through the performance of a walkthrough. Paragraphs 64-65 (as well as paragraphs 34 and 37 of AS No. 5) appear to indicate that walkthroughs *would* be sufficient for the purpose of evaluating whether a control has been implemented as designed. We agree and, accordingly, we recommend the Board clarify within the second note to paragraph 20 that a walkthrough would "ordinarily" be sufficient for this purpose.
4e	Paragraph 33 of the proposed standard requires the auditor to obtain an understanding of control activities that is "sufficient to assess the factors that affect the risks of material misstatement." As currently drafted, we are concerned that this could be interpreted to require an auditor to identify and obtain an understanding of *all* control activities addressing all the risks of misstatement for all relevant assertions. We believe such a requirement would go significantly beyond the existing requirement for financial statement-only (non-integrated) audits where an auditor would ordinarily only be required to obtain an understanding of controls sufficient to plan the audit (see paragraph 25 of the PCAOB's interim standard AU 319, *Consideration of Internal Control in a Financial Statement Audit*). Because the auditor may employ an audit strategy that does not encompass relying on controls in all areas, the requisite understanding of internal control would be much more limited under current standards than what might be inferred from the requirement in the proposed standard. To avoid confusion and unnecessary work, we believe it would be helpful to add the following statement to paragraph 33 "An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them." This additional sentence is consistent with existing PCAOB standards, paragraph 20 of the proposed standard, and ISA 315.
4f	Paragraph 42 – This paragraph states that "If the auditor has obtained other information relevant to identifying risks of material misstatement through other engagements performed for the company, the auditor should take that

	into account in identifying risks of material misstatement." In the release to the proposed standard, it appears that the Board's intent was for the auditor to consider and document the effect of *all* engagements performed by the firm when assessing risks. We are concerned that this is a requirement that extends beyond the existing guidance in AU 9311, *Planning and Supervision: Auditing Interpretations of Section 311*, and that may result in significant effort without a corresponding benefit to audit quality. Therefore, we recommend that the Board reconsider this requirement. We believe the language included in the PCAOB's interim standard, AU Section: 9311 provides the appropriate responsibility for considering other engagements performed by the firm; it states the following: "The auditor should consider the nature of non-audit services that have been performed. He should assess whether the services involve matters that might be expected to affect the entity's financial statements or the performance of the audit…." We recommend similar language be included in the proposed standard.
4g	Paragraph 54 –This paragraph requires auditors to identify other individuals within the company to whom inquiries about their views regarding fraud risks should be directed. While we acknowledge that improvements have been made from extant AU 316.24 in the proposal, we recommend that certain deleted words be reinstated. We recommend that certain deleted words from paragraph 24 of the PCAOB's extant AU 316, the source for paragraph 54, be reinstated. Specifically, we recommend changes in the following sentence. "The auditor should identify other individuals within the company to whom inquiries should be directed <u>and determine the extent of such inquiries</u> by considering whether others in the company might have additional knowledge <u>that will be helpful to the auditor in identifying risks of material misstatement due to</u> ~~about~~ fraud, alleged or suspected fraud …." Retaining the extant language will make clear that the auditor is to make a determination about the extent of such inquiries and explicitly relates the need for these inquiries to the risks of material misstatement.
4h	Paragraph 56 – This paragraph sets forth a process for identifying and assessing the risks of material misstatement using the information obtained from the risk assessment procedures and other relevant knowledge possessed by the auditor. Paragraph 56d requires auditors to consider the likelihood and magnitude of potential misstatements to assess the possibility that the risk could result in a material misstatement of the financial statements. However, we note that paragraph 56f, which requires auditors to determine whether any of the identified and assessed risks of material misstatement are significant risks, does not contain similar language related to an auditor's consideration of likelihood and magnitude

	when evaluating whether an identified risk is a significant risk. While the Note to 56f correctly states that the determination of significant risk is based on inherent risk, without regard to the effect of controls, we believe an auditor's evaluation of whether or not a risk is significant when evaluating inherent risk includes consideration of the likelihood and magnitude of the risk of misstatement. As such, we recommend the Board clarify the note to 56f that likelihood and magnitude are factors for consideration in significant risk determinations.
4i	Paragraph 62 – This paragraph contains requirements related to objectives for the auditor to achieve to understand the likely sources of misstatement, including a requirement to identify controls that a company has implemented to address potential misstatements. While these are largely consistent with AS No. 5, we note that in a financial statement audit an auditor ordinarily would only be required to obtain an understanding of controls sufficient to plan the audit. Therefore, we request the Board to consider whether such a requirement significantly enhances the auditor's ability to plan and perform the audit given the potential increase in costs this identification may require, particularly in financial statement audits where auditors may elect not to rely on a company's controls. See related discussion in comment 4e above.

	Appendix 5: The Auditor's Responses to the Risks of Material Misstatement
5a	Paragraph 2 – The objective as defined appears to be inconsistent with the discussion in paragraph 3. Paragraph 3 clarifies that to meet the objective of the standard, the auditor must address the risks that are identified and *assessed* in accordance with the proposed standard, *Identifying and Assessing Risks of Material Misstatement*. The objective does not include the notion of addressing the risks "assessed" by the auditor. We recommend that the Board add the word "assessed" to the objective to clarify the auditor's responsibilities. While we support the Board's changes to include the concept of "assessed risk" to create a better linkage to audit responses, we believe that the objective of the standard should include "assessed risk" to make this same linkage.
5b	Paragraph 5 – This paragraph requires the auditor to design and implement overall responses to address the assessed risks of material misstatements. More specifically, item 5c of this requirement entitled "*Incorporating elements of unpredictability in the selection of audit procedures to be performed*" indicates that the auditor should incorporate an element of unpredictability in the selection of auditing procedures to be performed from year to year as part of the auditor's response to the assessed risks of material misstatement due to error and fraud. While we believe that the

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	focus of incorporating an element of unpredictability into the auditor's procedures should be based on the auditor's response to the assessed risks of material misstatement due to fraud, we recommend that the PCAOB consider providing additional clarity regarding its application in response to risks other than fraud risks.
5c	Paragraph 6 – This paragraph requires the auditor to "… evaluate whether it is necessary to make pervasive changes to the nature, timing, or extent of audit procedures to adequately address the assessed risks of material misstatement. Examples of such pervasive changes include performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence." Given the overall requirements of the proposed standard is to address the risks of misstatement by obtaining sufficient appropriate evidence, we do not believe the term "pervasive" is needed and could result in confusion to the underlying requirement.
5d	Paragraph 31 – This paragraph provides guidance to assist auditors in determining to what extent evidence obtained in past audits related to the design and operating effectiveness of controls can impact the evidence needed to support the auditor's control risk assessments during the current year audit. While we recognize that this paragraph is largely consistent with the requirements of AS No. 5, we believe it could be interpreted as requiring auditors to evaluate and document their considerations of *all* controls tested in connection with the prior year audit and consequently could result in a significant increase in effort without providing a commensurate benefit to audit quality. We note that the requirement in AS No. 5 is intended to allow the auditor's experience in prior years to inform its assessment of risk, which in turn impacts the nature, timing and extent of testing necessary. As such, we recommend the PCAOB modify paragraph 31 to be consistent with paragraphs 47, 57 and 58 of AS No. 5 to better articulate the requirement.

	Appendix 6: Evaluating Audit Results
6a	Paragraph A2 of Appendix A in the proposed standard defines the word "misstatement;" however, due to the sequencing of the sentences, the definition could instead be interpreted as defining "material misstatement." As a result, we recommend that the PCAOB move the second sentence, which deals simply with "misstatement," to the first sentence of the paragraph.
6b	Paragraph 15 – This paragraph includes guidance for the auditor to communicate accumulated misstatements to management on a timely basis to provide them with an opportunity to correct them. Both the IAASB and

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	ASB standards include a requirement that the auditor request management to correct those misstatements and to understand management's reasons, if any, for not making the corrections. We believe that understanding management's rationale for not correcting misstatements could provide the auditor with perspective that could enhance the risk assessment, including the fraud risk assessment. In addition, requiring the auditor to make such a direct and specific request of management may improve the likelihood that such corrections will be made in the current period. As such, we believe this requirement should also exist in the PCAOB standards.
6c	Paragraphs 28 and C1 – Paragraph 28 provides that when evaluating the results of the audit, the auditor should evaluate whether the accumulated results of audit procedures and other observations affect the assessment of fraud risks made throughout the audit and whether audit procedures need to be modified to respond to those risks. This paragraph also references Appendix C, which is titled "matters that might affect the assessment of fraud risks." However, paragraph C1 lists matters, if identified during the audit, that "…the auditor should determine whether the assessment of fraud risks remains appropriate or needs to be revised." This seems to indicate that the auditor is required to determine if each item identified during the audit individually affects the assessment of fraud risks, which appears inconsistent with paragraph 28. We recommend the following sentence replace the first sentence of paragraph C1 in order to be consistent with paragraph 28 and the title of Appendix C – "The following matters might affect the auditor's assessment of fraud risks, including whether that assessment remains appropriate or needs to be revised."

	Appendix 7: Audit Evidence
7a	Paragraph 18 – The original proposed standard included a description that "[w]ritten confirmations might be received in paper form, or by electronic or other medium." We note that this description is excluded from the proposed standard. While we understand the PCAOB is in the process of considering amendments to its interim standard, AU 330, *The Confirmation Process*, we are concerned that the removal of the expectation that confirmations be "written," could have an effect on the auditor's evaluation of information provided from third parties as part of the audit. As such, we recommend that the Board consider re-inserting the word "written" in the first sentence so it refers to a "direct written response." We believe such language would better maintain the existing guidance until the completion of the Board's current project on confirmations.
7b	We note that a number of terms are used in this standard to describe the nature of audit evidence obtained through the audit. For example, the

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	words, "sufficiency," and "appropriateness" are used throughout to describe the characteristics of evidence that auditors are required to evaluate in order to conclude the evidence they have obtained is both sufficient and appropriate to support the related assertion. These terms, however, are not formally defined. We recommend that the Board consider providing formal definitions for these terms, using the guidance in paragraphs 5 and 6 of the proposed standard, which would allow them to be easily located within the standards as well as promote consistency in performance of audits.

	Appendix 8: Proposed Amendments to PCAOB Standards
8a	Proposed amendments to AU 350 – We are concerned that the suggested amendments to paragraph 23A and 38 of AU 350, *Audit Sampling*, would require auditors who use non-statistical sampling methods, to calculate sample sizes using both statistical and non-statistical approaches in all circumstances in order to be in a position to be able to demonstrate that the sample size under the non-statistical method equaled or exceeded a sample size under a statistical method. In Appendix 9 of the proposal, the Board stated "[t]he proposed amendments are not intended to require auditors to compute sample sizes using statistical methods in all instances to demonstrate compliance with the requirements." Although we appreciate that the Board addressed the meaning of the proposed amendments, we recommend the Board include this guidance within the standard itself to avoid potential confusion or misinterpretation. The potential guidance could leverage the language used in the release or, alternatively, language similar to paragraph A11 of redrafted ISA 530 or footnote 5 from paragraph 23 of the ASB's revised AU 350.

MAZARS

Paris La Defense, March 2, 2010

Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street, N.W.
Washington, DC 20006, USA
Attention: J. Gordon Seymour, Secretary, and the Members of the Board

Re: PCAOB Release No. 2009-007 December 17, 2009 - Rulemaking Docket Matter No. 026 - Mazars comments to the PCAOB request for public comment on Re-proposed Auditing Standards related to the Auditor's Assessment of and Response to Risk and Proposed Conforming Amendments to PCAOB Standards

Dear Sirs,

Mazars is a unique integrated partnership with a global reach. It operates as one integrated international partnership in 55 countries with more than 12,000 professionals, leaded by more than 600 partners, with 16 additional countries where Mazars is present through correspondents and joint ventures (see Mazars 2009 annual report with its recent update, its 2009 IFRS joint-audited consolidated financial statements, and all the annual reports published since 2005 on http://www.annualreport.mazars.com/eng/).

Mazars is one of the founding members of ‘Praxity’, an alliance of 109 firms operating in 72 countries with more than 24,500 professionals, and an aggregated fee income of US$ 3.2 billion (Euro € 2.3 billion), including Mazars Group. Praxity is the world’s largest alliance of independent accounting firms and is ranked in 8th position overall (International Accounting Bulletin’s survey of Networks and Associations).

Mazars has built a complete range of audit, accountancy, tax, legal and advisory services, designed to create added-value and to contribute to the success of clients in small and large listed companies, public institutions, and high net-worth individuals. Mazars was founded with certain core values: Independence, Competence; Intellectual, ethical and moral rigour and integrity; Sense of service and responsibility; Continuity; Respect for individuals and diversity.

We are pleased to submit this letter in response to the request for public re-consideration from the PCAOB on its Re-proposed Auditing Standards related to the Auditor's Assessment of and Response to Risk and Proposed Conforming Amendments to PCAOB Standards.

Before specifically answering the below comment letter questions, we would like to make some general comments about these PCAOB proposed Auditing Standards and Conforming Amendments.

We want to preface our comments with the general consideration that we support implementation of rules and auditing standards strengthening the audit quality.

Praxity MEMBER GLOBAL ALLIANCE OF INDEPENDENT FIRMS

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Mazars is therefore fully committed to support PCAOB initiative, as well as those of IFAC, European Commission and other key national regulators or oversight that have been already doing good work and are implementing frameworks of coherent auditing standards worldwide, with clear audit objectives, in these areas of common concern.

Mazars is very supportive of the PCAOB's efforts to update its risk assessment standards while aligning them with AS5 (risk-based audit approach), considering fraud and auditing disclosures, and eliminating divergences with the risk assessment standards of the IAASB. It is also very refreshing to know that throughout this standard-setting process, the basics and fundamentals of risk assessments, as we know them, have remained the same. This is an evolution, and not a revolution.

We respectfully submit our detailed comments below. We commend the Board for the transparency of its rule deliberation process and for considering the work of the IFAC IAASB in its new standard-setting process.

1. **Are the objectives in the new proposed standards useful in providing context for the requirements in the standards?**

   Mazars believes that the objectives in the new proposed standards are useful and worthwhile because they provide additional context in understanding requirements of new standards. This is a standard-setting trend that was started by the IAASB (IFAC) and the ASB (AICPA) in their respective Clarity Projects.

2. **Does the new proposed standard on audit risk describe clearly the concept of audit risk and its components?**

   Mazars considers that the new proposed standard on audit risk clearly describes the concept of audit risk and its components: (1) risk of material misstatement (inherent risk and control risk) and (2) detection risk.

3. **Does the new proposed standard on audit risk describe clearly the relationship between detection risk and substantive procedures?**

   Mazars believes that overall the new proposed standard appropriately described the relationship between detection risk and substantive procedures. It indicates that detection risk could be reduced by performing substantive procedures, which is consistent with other PCAOB standards.

4. **Are the proposed requirements for multi-location engagements appropriately aligned with Auditing Standard No. 5?**

   The proposed requirements for multi-locations are appropriately aligned with AS5. Most of the risks associated with multi-locations are adequately accounted for.

5. **Is it clear how the proposed requirements for multi-location engagements would be applied in audits of financial statements only?**

   The proposed requirements for multi-location engagements are AS5 aligned and driven. Consequently, they would be applied in audits of financial statements only.

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6. Are the differences between the responsibilities for supervision of engagement team members and oversight of specialists in accordance with AU sec. 336 appropriate in light of the auditor's responsibilities to opine with reasonable assurance on whether the financial statements are fairly presented, in all material respects, in conformity with the applicable financial reporting framework?

Mazars considers that the differences between the responsibilities for supervision of engagement team members and oversight of specialists in accordance with AU sec. 336 are appropriate. Both responsibilities for supervision are distinct and separate. The supervision of engagement team members requires the auditor to ensure among other things that audit objectives are reached and that audit evidence is adequate and sufficient to support the opinion expressed. Whereas, the oversight of specialists requires the auditor to ensure that these specialists are independent and competent, and the scope, objectives, and results of their procedures agree with those of the auditor.

7. Are the provisions in the new proposed standard regarding consideration of materiality in multi-location engagements appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?

The provisions in the new proposed standard regarding consideration of materiality in multi-location engagements appear fairly appropriate. Auditors' attention is drawn to the fact that materiality at an individual location cannot exceed, and generally should be less than materiality for the financial statements as a whole. Nevertheless, as the IFAC-IAASB, the PCAOB should consider providing additional guidance or examples on how to apply these provisions.

8. Are the revised provisions regarding reassessment of materiality appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?

The revised provisions regarding reassessment of materiality appear appropriate, and this is consistent with the audit risk-based approach advocated by AS5.

The auditor is required to adapt his/her audit approach or audit strategy to changing circumstances or environments, including reassessing materiality level.

9. Does the new proposed standard adequately describe the auditor's responsibilities for performing risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of risks of material misstatement due to error or fraud and to design further audit procedures?

Mazars believes that the new proposed standard adequately describe the auditor's responsibilities for performing risk assessment procedures.

10. Are the auditor's responsibilities regarding the additional procedures for understanding the company and its environment in paragraph 11 clear?

Mazars would support the auditor's responsibilities regarding the additional procedures for understanding the company and its environment as stated in paragraph 11, as they are clear. However, we recommend that this proposed standard also state the fact that these examples of additional procedures are not "all inclusive".

11. Are the proposed requirements regarding obtaining an understanding of internal control over financial reporting appropriate in light of the auditor's responsibilities for identifying and assessing the risks of material misstatement?

Mazars believes that the proposed requirements regarding obtaining an understanding of internal control over financial reporting are appropriate.

12. Are the proposed requirements regarding the discussion among engagement team members about risks of material misstatement appropriate given the auditor's responsibilities for identifying and assessing the risks of material misstatement?

The proposed requirements regarding the discussion among engagement team members about risks of material misstatement are also appropriate.

13. Are the proposed requirements for overall responses and responses involving the nature, timing, and extent of audit procedures appropriate given the auditor's responsibility to opine with reasonable assurance about whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?

Mazars agrees that the proposed requirements for overall responses and responses involving the nature, timing, and extent of audit procedures, are appropriate.

14. Does the new proposed standard clearly describe when tests of controls are necessary in an audit of financial statements only?

The new proposed standard clearly describes when tests of controls are necessary in an audit of financial statements only. The auditor would continue to have the latitude of deciding when or whether to test controls and reduce substantive procedures.

15. Does the new proposed standard clearly describe the auditor's responsibilities for accumulating and evaluating misstatements?

Mazars believes that the new proposed standard clearly describes the auditor's responsibilities for accumulating and evaluating misstatements. The proposed audit procedures and considerations for accumulating and evaluating misstatements appear adequate.

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16. Does the new proposed standard appropriately describe the auditor's responsibilities for evaluating the presentation of the financial statements, including evaluating bias, in light of the auditor's responsibility to opine with reasonable assurance on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?

The new proposed standard appropriately describes the auditor's responsibilities for evaluating the presentation of the financial statements, including evaluating bias. Auditors are appropriately directed to evaluate adequacy of the amounts and disclosures in the financial statements, including potential bias.

17. Does the new proposed standard describe clearly how the auditor should determine the financial statement assertions to use for both integrated audits and audits of financial statements only?

Mazars believes that the new proposed standard describes clearly how the auditor should determine the financial statement assertions to use for both integrated audits and audits of financial statements only. The financial statements assertions to be used for either audit of financial statements or audit of ICFR have the same and unchanged guiding principles.

18. Are there provisions in the to-be-superseded standards that should be retained?

Mazars considers that the most meaningful provisions in the soon-to-be-superseded six interim auditing standards, notably AU sec. 311, Planning and Supervision, AU sec. 312, Audit Risk and Materiality in Conducting an Audit, AU sec. 313, Substantive Tests Prior to the Balance Sheet Date, AU sec. 319, Consideration of Internal Control in a Financial Statement Audit, AU sec. 326, Evidential Matter, and AU sec. 431, have already been retained and accounted for.

We hope that our comments above will be helpful and we remain available for further considerations. Please feel free to contact us again if you would like to discuss our submission further.

Yours sincerely,

Denis Usher
Mazars US Desk

Jean-Luc Barlet
Mazars Chief Compliance Officer

McGladrey & Pullen
Certified Public Accountants

McGladrey & Pullen, LLP
Third Floor
3600 American Blvd West
Bloomington, MN 55431

March 2, 2010

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: Request for Public Comment - *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk*, and *Related Amendments to PCAOB Standards*, PCAOB Rulemaking Docket Matter No. 026

Dear Office of the Secretary:

McGladrey & Pullen, LLP (McGladrey) appreciates the opportunity to offer our comments on the *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Related Amendments to PCAOB Standards* (the reproposed standards). McGladrey is a registered public accounting firm serving middle market issuers.

As noted in our previous comment letter dated February 20, 2009, we support the Board's efforts to update its existing standards related to the requirements for assessing and responding to risks in an audit. Further, we appreciate the changes and improvements the PCAOB has made from the original proposed auditing standards.

Our comments are organized by those that are general in nature, followed by those that relate to specific standards.

<u>Eliminate unnecessary differences between the Board's standards and other standards</u>

Virtually all public accounting firms registered with the PCAOB also audit nonissuers under the International Auditing and Assurance Standards Board's (IAASB), *International Standards on Auditing (ISAs)* and the AICPA's Auditing Standards Board's (ASB), *Statements on Auditing Standards (SASs)*. As the demand on U.S. public accounting firms to conduct audits under the ISAs increases, auditors will be required to master this third set of standards.

We recognize the PCAOB's significant efforts in the reproposed standards towards reducing differences between its standards and the ISAs and SASs. We also recognize the PCAOB's efforts towards providing clarity as to its rationale for many such differences in Appendix 9, *Additional Discussion of New Proposed Auditing Standards and Comments on Original Standards Proposed in October 2008*. However, many differences remain that we believe are not intended to result in a different decision or action by the auditor. (Examples of such differences are included in the Center for Audit Quality (CAQ) comment letter and in our Firm's and the CAQ's comment letters on the original proposed standards.) Unnecessary differences between the Board's standards and those of other standard-setters increase the costs of performing *all* audits because firms must develop and maintain two, and even three, audit methodologies and training programs, with no corresponding benefit to audit quality. In fact, these unnecessary differences can lead to confusion and misunderstanding by auditors of what is required of them and why, which potentially leads to an erosion of audit quality. We encourage the PCAOB to minimize or eliminate differences between its standards and those of other standard-setters when no difference in an objective or in a decision or action by the auditor is intended.

Organization of the standards

We encourage the Board to undertake a project to improve the consistency in the form and style of its standards. We also urge the Board to provide a codification of its standards, which we believe would facilitate better understanding and implementation of the Board's standards.

In addition, we suggest that all requirements of the auditor be placed in the main body of the standards. For example, paragraph 56.c. of Appendix 4, *Identifying and Assessing Risks of Material Misstatement*, states "…the auditor should evaluate how risks at the financial statement level could affect risks of misstatement at the assertion level." In addition, paragraph B.1 in Appendix B of the same proposed standard states, "...the auditor should obtain an understanding of how the company uses information technology ("IT") and how IT affects the financial statements." Embedding requirements in the notes and appendices can result in auditors' failure to identify and implement those requirements.

Standards-setting process

We appreciate the Board's improvements in the transparency of its standards-setting process; in particular its re-exposure of the proposed standards, its detailed responses to the comments received, and explanations of its rationale where it believes differences between the reproposed standards and those of other standards-setters are warranted. We agree with the CAQ's recommendations for further enhancements to the PCAOB's standards-setting process, including:

- Highlighting expected changes in auditor performance.
- Providing detailed comparisons of proposed standards with existing PCAOB, IAASB and ASB standards.
- Increasing collaboration with IAASB and ASB in developing auditing standards.
- Establishing task forces that include members of the auditing profession to provide a practicing auditor's perspective, which would allow the Board to identify potential implementation issues and enhance auditors' understanding of the Board's standards.

Effective date of the standards

The Board's proposed effective date (audits of fiscal years beginning on or after December 15, 2010) may not provide sufficient time between the date of approval by the Board and the SEC and the date on which firms could be ready for implementation. As a practical matter, changes in standards need to be finalized early in a calendar year to allow firms time to revise policies and methodologies by mid-year and train their professionals during the summer CPE season in order to be in a position to implement the policies as of calendar year end. Accordingly, we request that if the standards have not been approved by the Board and the SEC by April 30, 2010, the Board change the effective date to audits of fiscal years beginning on or after December 15, 2011.

Following are our observations on specific paragraphs of the proposed standards:

1. Appendix 2 (Proposed Auditing Standard – *Audit Planning and Supervision*).
    a. Paragraph 13 regarding multi-location engagements addresses how an auditor takes into account the activities of internal auditors or others in accordance with AU sec. 322 but does not address how an auditor takes into account the audits performed by other auditors on components of the entity in accordance with AU sec. 543. We recommend the Board add a paragraph to explain how paragraphs 11 – 12 would be applied in that situation.
    b. We believe paragraphs 16 -19 could lead to confusion, particularly in regards to the phrase "who participates in the audit," which could be interpreted a number of ways. We suggest the PCAOB consider the approach taken by the IAASB in ISA 220, *Quality Control for an Audit of Financial Statements,* and in ISA 620, *Using the Work of an Auditor's Expert.* Under these standards, when the auditor uses professionals in specialized areas of accounting and auditing, they are treated as members of the engagement team, regardless of whether they are employees of the firm or outside professionals, and professionals or organizations that provide assistance in fields other than accounting or auditing are deemed "auditor's specialists."

2. Appendix 3 (Proposed Auditing Standards – *Consideration of Materiality in Planning and Performing an Audit*). We ask the Board to reconsider the use of the term "tolerable misstatement" in the context of assessing risks of material misstatement and planning and performing audit procedures. While we agree that auditors understand the term "tolerable misstatement," that understanding is currently applied in the context of audit sampling. Changing the context for use of this term from its current context, as well as the use of the same term as the ISAs in a different context, will lead to confusion among auditors. We recommend that the Board instead use the term "performance materiality" to be consistent with ISA 320.

3. Appendix 4 (Proposed Auditing Standard – *Identifying and Assessing Risks of Material Misstatement*).

    a. The definition of "significant risk" in Appendix A is different from that in the corresponding ISA and proposed SAS. We recommend the Board adopt the same definition to avoid confusion by auditors, or otherwise provide an explanation of the difference.

    b. We suggest the Board clarify that, since the auditor's identification of necessary disclosures in accordance with paragraph 13 is performed as part of the auditor's risk assessment procedures in the planning stage of the audit, that this is a preliminary identification that should be reevaluated at the conclusion of the engagement.

4. Appendix 5 (Proposed Auditing Standard – *The Auditor's Response to the Risks of Material Misstatement*). Paragraph 5.c. and the related Additional Discussion in Appendix 9 appear to require the auditor to incorporate elements of unpredictability in the selection of audit procedures in response to risks of material misstatement due to fraud and error. We do not believe unpredictable procedures are effective in detecting misstatements due to error and *we further believe the action requir*ed by the auditor in this regard is unclear. Accordingly, we recommend the Board reinstate the language from the October 21, 2008 release, which placed this requirement in the context of responding to the risk of fraud.

We would be pleased to respond to any questions the Board or its staff may have about these comments. Please direct any questions to either Bob Dohrer (919.645.6819) or Susan Menelaides (602.760.2827).

Sincerely,

McGladrey & Pullen, LLP

McGladrey & Pullen, LLP

From: cpa@hawkm.com [mailto:cpa@hawkm.com]
Sent: Sunday, December 20, 2009 4:58 PM
To: Comments
Cc: Wilson, Keith; Ahmad, Hasnat; Jules, Diane; Watts, Jessica; Zhao, Hong
Subject: PCAOB Rulemaking DocketMatter No. 026

December 20, 2009

PCAOB,

In my view, the re-proposed risk assessment standards do not strike a good balance between what is arguably the most important elements of financial statements (i.e. significant accounts and disclosures) and so-called "relevant assertions."

I recommend you consider deleting as many references as possible to "relevant assertions" to increase the relative weight and importance of "significant accounts and disclosures."

After all, auditors have a difficult enough time dealing with significant accounts and disclosures so the PCAOB should minimize theory oriented distractions to how accountants operate and financial statements are prepared in the real world.

I believe the *Universal Financial Assertions* contained in the attached document are much more practical and logical than the five [actually nine] assertions contained in AS #5 and the even higher number of assertions developed in recent years. In my view, the *Universal Financial Assertions* can be used by external auditors, internal auditors, accountants, company operations staff, public companies, private companies, non-profits, etc.

The views expressed above and in the attached documents are my own and are not associated with any company or organization I have ever been associated with.

Sincerely,
Patrick Montgomery
11808 Wayland Street
Oakton, VA 22124
cpa@hawkm.com

cc: PCAOB Staff

Intelligent Auditing results in quality audits at a cost comparable to legacy audits.

Intelligent auditors collaborate with their clients to improve audit efficiency and minimize audit risk.

Intelligent audits are typically based on:

- ***more relevant and appropriate*** audit evidence,
- ***more reliable*** audit evidence, and/or
- ***more sufficient*** audit evidence.

Intelligent auditors leverage information technologies including spreadsheet software, database management systems, general purpose audit software, email, virtual private networks (VPN), file transfer protocol (FTP), and cloud computing.

Intelligent auditors exercise professional skepticism.

Intelligent auditors are effective at identifying significant accounts and risks of material misstatements.

Intelligent auditors will at times test very large samples and/or entire populations.

Intelligent auditors are proficient at analyzing and electronically comparing relevant data contained in important systems, including consolidation systems, general ledgers, sub-ledgers, ERP applications, business systems, and electronic data available from third parties (e.g. financial institutions, trading partners, and company service providers).

Intelligent auditors leverage treasury, cash management, and banking data.

Intelligent auditors are provided complete access to client data and information.

Intelligent auditors are guided by the standards of the International Auditing and Assurance Standards Board (IAASB) and/or the U.S. Public Company Accounting Oversight Board (PCAOB).

Intelligent audits are usually structured around the following five (5) ***Universal Financial Assertions***:

- ***ANO*** accounts are not overstated
- ***ANU*** accounts are not understated
- ***APC*** accounts are properly classified
- ***DCA*** disclosures are complete and accurate
- ***ICE*** internal controls are effective

Universal Financial Assertions		CASH ACCOUNTS	ASSET ACCOUNTS	LIABILITY ACCOUNTS	EQUITY ACCOUNTS	REVENUE ACCOUNTS	EXPENSE ACCOUNTS
ANO	accounts are not overstated	priority audit procedures	priority audit procedures	other audit procedures	priority audit procedures	priority audit procedures	other audit procedures
ANU	accounts are not understated	priority audit procedures	other audit procedures	priority audit procedures	other audit procedures	other audit procedures	priority audit procedures
APC	accounts are properly classified	important element of ANO and ANU testing above					
DCA	disclosures are complete and accurate	priority audit procedures for external financial statements					
ICE	internal controls are effective	priority audit procedures for integrated audits and ICFR audits					

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T 206-302-6800
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March 2, 2010

SENT VIA EMAIL TO COMMENTS@PCAOBUS.ORG

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: Request for Public Comment: *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Related Amendments to PCAOB Standards*, PCAOB Rulemaking Docket Matter No. 026

Dear Office of the Secretary:

We appreciate the Public Company Accounting Oversight Board's (the Board or PCAOB) willingness to expose its revised *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, and Related Amendments to PCAOB Standards* (the reproposal or reproposed standards). We acknowledge the Board's careful consideration of the comments it received on the original proposal, and we appreciate the continued opportunity to share our views on the subject reproposal. We believe the Board's efforts to gather and incorporate input from a variety of interested parties, including public accounting firms our size, benefits the standards-setting process and contributes to advancing the Board's mission to improve audit quality. As a result, we look forward to additional opportunities for involvement in the Board's future standards-setting activities.

We believe significant improvements have been made in the reproposed standards as compared with the original proposal. In particular, the Board's efforts to better align and integrate the reproposed standards with Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and AU 316, *Consideration of Fraud in a Financial Statement Audit,* have had the desired effect of clarifying the auditor's responsibilities when performing a financial statement audit only, while continuing an emphasis on fraud-related audit procedures.

As stated in our comment letter related to the original proposal, we support the Board's direction in updating public company auditing standards to reflect a more risk-based approach, and we agree with the basic principles of the reproposed standards. While we generally support the changes made by the Board, we believe additional clarification is needed for the successful and consistent understanding and application of the reproposed standards. Our comments and recommendations are provided in the following sections in the remainder of this letter:

- Style of the reproposed standards: Use of notes and appendices
- Organization and codification of PCAOB standards
- Effective date
- Differences between PCAOB and other standards-setters' standards
- Observations related to PCAOB's standards-setting process
- Comments on individual standards

Style of the Reproposed Standards: Use of Notes and Appendices

Similar to the original proposal and as we noted in our previous comment letter, the reproposed standards represent a third "style" of PCAOB standards that is inconsistent with many of the Board's other standards (i.e., interim standards and AS No. 1-6). This style includes the drafting convention that makes more extensive use of notes and appendices and places requirements within them.

We note that the Board stated in its release[1] with the reproposed standards that the notes and appendices in the Board's auditing standards are considered integral parts of the standards and accordingly, carry the same authoritative weight as the other portions of the reproposed standards. While we do not dispute this, we believe the inclusion of requirements in notes and appendices serves to devalue the requirements and may increase the likelihood that auditors could overlook those particular requirements. Similar to the Board's rationale for incorporating the guidance from the Board's interim standards related to fraud into the respective auditing standards to emphasize the auditor's responsibilities for consideration of fraud at various stages of the audit, we recommend the Board consider incorporating requirements currently located in appendices into the body of the applicable standards.

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[1] We noted the reference in footnote 6 of Appendix 9 of the reproposal refers to Questions No. 1 and 2 of *Staff Questions and Answers: Auditing Internal Control Over Financial Reporting* (June 23, 2004 and revised July 27, 2004). However, this guidance has been superseded according to the PCAOB website.

This drafting convention also may create more complexity than necessary in referring to the requirements. Specifically, the existence of requirements within notes may make it difficult for the PCAOB and auditors to easily identify and refer to all requirements within the PCAOB standards. We recommend the PCAOB consider utilizing paragraphs, as opposed to notes, in all situations where it is establishing a requirement.

Organization and Codification of PCAOB standards

The multiple "styles" of PCAOB standards, as described above, result in a set of PCAOB auditing standards that is increasingly cumbersome to navigate. While the Board indicated in the release that the style of the reproposed standards will provide a template for future standards issued by the Board, there does not appear to be a clearly stated plan for updating existing standards in the future, nor for clearly codifying all auditing standards adopted by the PCAOB. Given the PCAOB's current extensive standards-setting agenda, we are concerned that new standards may exacerbate the difficulty of navigating and applying new standards with the remaining interim standards without a consistent style, a plan for updating existing standards, as well as codification of all Board auditing standards. Therefore, we recommend that the PCAOB consider undertaking a project, similar to that undertaken by the AICPA Auditing Standards Board (ASB) and the International Auditing and Assurance Standards Board (IAASB), to redraft all of its auditing standards in a consistent manner (e.g., consistent use of objectives), with the intent of encouraging greater understanding and more consistent application, and to fully codify the standards by subject matter. While we recognize that the PCAOB's resources are limited, we believe such projects, and the potential benefits to auditor understanding and performance, merits priority on the Board's agenda.

Effective date

We appreciate that the PCAOB responded to comments received from the original proposal by including a proposed effective date in the release to the reproposed standards. We agree that the effective date should be as of the beginning of an audit period. However, given the time required to consider public comments received and obtain Board and SEC approval, the PCAOB's expectation that the standards would be effective for audits of fiscal years beginning on or after December 15, 2010, may be aggressive.

Due to the foundational nature of the proposed standards, the effective date for the standards should consider the time required for firms to incorporate the standards into their audit methodologies and training programs prior to implementation. Therefore, if the final standards are approved by the Board and the SEC after June 30, 2010, we strongly request the Board consider a later effective date.

Differences between PCAOB and other standards-setters' standards

We recognize the improvements the Board has made to reduce differences between the reproposed standards and the IAASB's International Standards on Auditing (ISAs) and the ASB's Statements on Auditing Standards (SASs). For example, there are a number of areas in which the requirements and terminology in the reproposed standards are more closely aligned with the ISAs and SASs and in areas where differences remain, the Board generally provided its rationale for maintaining the differences.

We note that a large number of registered firms conduct audits in accordance with standards from the PCAOB, the ASB and the IAASB. As one of those firms that follow each set of standards, we are concerned with how the PCAOB's standards interact with those of other standards setters. An accurate understanding and consistent application of the requirements and terminology of each set of standards is required to achieve high quality audits. Consistency of each set of standards, to the extent appropriate, allows an auditor and an audit firm to concentrate efforts on conducting a high-quality audit.

As a result, we recommend the PCAOB seek to achieve the following three objectives when drafting its standards:

1. Minimize differences between PCAOB and other standards-setters' standards in terminology and requirements. We recognize that the Board may decide that different procedures are appropriate in the U.S. public company audit context. However, we encourage the Board to continue to minimize the differences in its standards to only those matters that are unique to audits of issuers in the U.S. Minimizing differences also allows firms to cultivate synergies related to training, implementation, and the development and maintenance of quality control systems that accommodate the standards of the various standards-setting bodies—all factors that we believe contribute to enhanced audit quality.

2. Clearly articulate the rationale for any differences. For those differences from other standards-setters that do exist, we encourage the Board to continue to

clearly and publicly explain the reasoning. We do not intend to put the PCAOB in a position of defending its choices. Rather, a public dialogue and communication about the Board's thought process would improve the understanding of the PCAOB's standards and the Board's intent for the differences.

3. Explain the desired auditor actions as a result of the differences. In situations where the underlying objectives and requirements between PCAOB standards and those of other standards-setters are similar, firms may generally presume that the PCAOB does not intend there to be a different auditor action unless it is specifically highlighted by the PCAOB (or otherwise clearly apparent within the context of the standard). As such, we continue to encourage the PCAOB to highlight the different procedures required in the U.S. public company audit context, being as comprehensive as possible in its explanations of the desired auditor actions as a result of the differences to assist firms in recognizing and implementing any intended differences.

We noted the following two areas in particular in the reproposed standards for which we strongly encourage the Board to reconsider whether the remaining differences in terminology and requirements are truly necessary, and if so, more clearly articulate the rationale and explain the desired auditor action as a result of the differences:

- The reproposed standard *Consideration of Materiality in Planning and Performing an Audit* uses the term "tolerable misstatement" (e.g., paragraphs 8 and 9). This is different from the term "performance materiality" used in ISA 320 (Revised and Redrafted), *Materiality in Planning and Performing an Audit*, and in the clarified issued SAS, *Materiality in Planning and Performing an Audit,* for essentially the same concept. For the reasons described in our comment on Appendix 3 below, we recommend that the PCAOB replace the term "tolerable misstatement" in the reproposed standard with "performance materiality."

- Paragraph 15 of the reproposed standard *Evaluating Audit Results* includes guidance for the auditor to communicate accumulated misstatements to management on a timely basis to provide them with an opportunity to correct them. Both the ISAs and SASs include a requirement that the auditor request management to correct those misstatements. We believe this requirement should also exist in the PCAOB standards. Requiring the auditor to make such a direct and specific request of management may improve the likelihood that such corrections will be made in the current period.

Observations related to PCAOB's standards-setting process

We request the Board consider further enhancements to its standards-setting process in the areas described below that would improve the clarity of its standards, provide additional visibility to the Board's rationale and desired changes to practice, and increase the consistency of implementing its auditing standards.

Release Text

We appreciate the Board providing insight into its thought process on certain aspects of the reproposal by including its consideration of the comments received on the original proposal. However, we are concerned that in some situations, it appears that in addition to providing insight into the Board's decision-making process, the Board is also attempting to interpret aspects of the standard in the release text. The following two instances provide examples:

- Paragraphs 11-14 of the reproposed standard *Audit Planning and Supervision* outline the auditor's responsibilities with respect to multi-location engagements. The Board states in Appendix 10 that these provisions "are applicable to all multi-location audits, not just group audits." However, we note that the Board's standards do not currently contain a definition of a "group audit," nor do the standards or the Board's release to the reproposed standards contain any discussion of what the similarities and/or differences between multi-location audits and group audits might be. Therefore, we request the Board to clarify its intent with respect to the application of these paragraphs.

- With respect to the proposed amendments to paragraphs 23 and 38 of AU 350, *Audit Sampling*, the Board clarified its view in Appendix 9 of the reproposal that "the proposed amendments are not intended to require auditors to compute sample sizes using statistical methods in all instances to demonstrate compliance with the requirements." Although we appreciate that the Board has attempted to address the concern expressed by commenters to the original proposal, we recommend the Board include this guidance within the standard itself to avoid potential confusion or misinterpretation. The potential guidance could leverage the language used in the release or, alternatively, language similar to paragraph A11 of redrafted ISA 530 or footnote 5 from paragraph 23 of the ASB's revised AU 350, *Audit Sampling*.

Interpreting standards through release text can result in potential confusion over the requirements within the related standard and result in inconsistent application by auditors. In addition, given that the release is not ultimately part of the final standard, any interpretive guidance contained within it may not be given the same consideration by auditors and other interested parties. This may create the need for supplemental staff interpretations on certain aspects of the standards, adding further complexity for the auditor implementing the standards. As a result, we encourage the Board to consider providing such interpretive guidance within its final standards as opposed to the accompanying release.

Highlight Desired Changes to Practice

We believe that providing specific descriptions of the Board's desired changes to current audit practice as a result of a proposal, final standard, or rule would assist auditors and other interested parties in understanding the changes expected from the relevant proposals or standards. We note that the Board could consider the approach utilized by the Financial Accounting Standards Board to provide this information.

Comments on individual standards

In addition to the comments provided above as examples, we observed the following opportunities to improve the clarity of several of the reproposed standards.

Appendix 2, Audit Planning and Supervision

Paragraph 7 – As in the original proposed standard, this paragraph includes a list of matters that auditors should evaluate to determine whether or not they are important to the company's financial statements and internal control over financial reporting and if so, how they will affect the auditor's procedures. The ninth bullet in the list requires the auditor to consider "preliminary judgments about the effectiveness of internal control over financial reporting." However, unlike the fifth bullet point related to the auditor's preliminary judgments of materiality, the ninth bullet is not clear that it refers to the auditor's judgments about effectiveness of controls. We recommend that the PCAOB modify the ninth bullet point to clarify that it pertains to the auditor's preliminary judgments or consider clarifying within the standard the intent behind the omission.

Paragraph 14 – This paragraph appears to create a narrower or more prescriptive requirement than the requirement set forth in paragraph 5c of the reproposed standard, *The Auditor's Responses to the Risks of Material Misstatement*, relating to introducing an element of unpredictability in the auditing procedures performed in multi-location engagements. Paragraph 14 appears to require auditors to change the nature, timing and extent of audit procedures performed at various locations each year, whereas paragraph 5c requires that auditors incorporate unpredictability, providing the varying of locations where procedures are performed as an example of how that might be achieved.

We do not believe it is necessary or recommended that risk-based auditing standards dictate the specific manner in which the element of unpredictability is to be introduced. Given that the requirement in paragraph 5 is intended to impact the auditor's overall response to the assessed risks of misstatement, including the risk of fraud, we recommend deleting paragraph 14 from this reproposed standard or including this paragraph only as an example to paragraph 5 of reproposed standard, *The Auditor's Responses to the Risks of Material Misstatement.*

Appendix 3, Consideration of Materiality in Planning and Performing an Audit

As in the original proposal, the reproposed standard uses the term "tolerable misstatement" (e.g., paragraphs 8 and 9), which is different from the term "performance materiality" used in ISA 320 (Revised and Redrafted), *Materiality in Planning and Performing an Audit,* and in the clarified issued SAS, *Materiality in Planning and Performing an Audit,* for essentially the same concept. As described by the Board in Appendix 9 of the reproposal, we recognize that the term is well understood by auditors and that the Board is not seeking to change the concept as described in existing PCAOB standards. However, the term is defined and largely understood by auditors in the context of audit sampling (as defined in AU 350, *Audit Sampling,* in the PCAOB's interim standards). Using the same term in two separate fashions – to both assist auditors in assessing risks of material misstatement for the purpose of determining an appropriate audit response and to plan a sample – could result in confusion for auditors and result in misapplication of the concepts, which in turn, could have adverse impacts on audit quality. Further, upon adoption of the revised and redrafted ISAs and SASs, auditors will become more familiar with the term "performance materiality". If the PCAOB persists in its proposed use of "tolerable misstatement", audit firms would be faced with incorporating into their audit methodologies and training programs different terminology for the same concepts among standards-setters. Therefore, to avoid potential confusion and unnecessary complexity, we recommend that the PCAOB replace the term "tolerable misstatement" in the reproposed standard with "performance materiality," which is the equivalent term used in the revised and redrafted ISAs and SASs to distinguish the term's meaning when used in separate aspects of the audit.

Appendix 4, Identifying and Assessing Risks of Material Misstatement

Paragraph 11 – This paragraph contains procedures an auditor should consider performing as part of obtaining an understanding of the company. We agree that information from such procedures, in many instances, would provide the auditor with meaningful insights into the company and therefore, enhance the assessment of risks. However, we note that the broad nature of the procedures, combined with the presumptively mandatory requirement, may result in auditors expending significant efforts to identify such information and/or documenting the considerations regarding the importance of such information to the auditor's understanding of the company. Such excess efforts may not result in a commensurate increase in audit quality. As such, we recommend the PCAOB consider amending the requirement to indicate that the auditor "might consider" the procedures outlined within the paragraph.

Paragraphs 13 and 68 – Paragraph 13 requires the auditor to identify the "necessary disclosures for the company's financial statements" in order to identify and assess the risks of material misstatement related to omitted or incomplete disclosures. Paragraph 68 states that the "auditor's evaluation of fraud risk factors…should include evaluation of how fraud could be perpetrated or concealed through omitting or presenting incomplete disclosures." We recommend that the PCAOB clarify in both of these instances that the auditor's identification, assessment, and evaluation of the risk of material misstatement related to omitted or incomplete disclosures is conducted in consideration of the company's financial reporting framework.

Appendix A5 – The definition of "significant risk" should make it clear that the auditor makes a determination of the areas that are deemed significant risk and thus require special audit consideration based on the auditor's assessment of the entity's risks. This concept is excluded from the definition in Appendix A. We believe the definition of significant risk would be improved by including the following language: "*Significant risk* – A risk of material misstatement that the auditor determines requires special audit consideration."

Paragraph 54 –This paragraph requires auditors to identify other individuals within the company to whom inquiries about their views regarding fraud risks should be directed. We recommend that certain deleted words from paragraph 24 of the PCAOB's extant AU 316, the source for paragraph 54, be reinstated. Specifically, we recommend making the following changes to the second sentence, "The auditor should identify other individuals within the company to whom inquiries should be directed and determine the extent of such inquiries by considering whether others in the company might have additional knowledge that will be helpful to the auditor in identifying risks of material misstatement due to ~~about~~ fraud, alleged or suspected fraud ..." Retaining the extant language will make clear that the auditor is to make a determination about the extent of such inquiries and explicitly relates the need for these inquiries to the risks of material misstatement.

Appendix 5, The Auditor's Responses to the Risks of Material Misstatement

Paragraph 2 – The objective in paragraph 2 could be clarified to reflect the additional perspective provided by the discussion in paragraph 3. Paragraph 3 clarifies that to meet the objective of the standard, the auditor must address the risks that are identified and assessed in accordance with the reproposed standard, *Identifying and Assessing Risks of Material Misstatement.* As currently drafted, the objective in paragraph 2 does not include the notion of addressing the risks "assessed" by the auditor. We recommend that the Board add the word "assessed" before the phrase "risks of material misstatement" in the objective to clarify the auditor's responsibilities. While we support the Board's changes to include the concept of "assessed risk" to create a better linkage to audit responses, we believe that the objective of the standard should include "assessed risk" to make this same linkage.

Appendix 6, Evaluating Audit Results

Paragraphs 28 and C1 – Paragraph 28 provides that when evaluating the results of the audit, the auditor should evaluate whether the accumulated results of audit procedures and other observations affect the assessment of fraud risks made throughout the audit and whether audit procedures need to be modified to respond to those risks. Paragraph 28 also references Appendix C, which is titled "Matters That Might Affect the Assessment of Fraud Risks." Paragraph C1 lists matters, if identified during the audit, for which "...the auditor should determine whether the assessment of fraud risks remain appropriate or needs to be revised." This seems to indicate that the auditor is required to determine if each listed item identified during the audit individually affects the assessment of fraud risks, and appears to be inconsistent with paragraph 28. This may lead to confusion about the level of consideration and documentation expected in these situations. We recommend the following sentence replace the first sentence of paragraph C1 to be consistent with paragraph 28 and the title of Appendix C: "The following matters might affect the auditor's assessment of fraud risks, including the auditor's evaluation of whether that assessment remains appropriate or needs to be revised."

Appendix 7, Audit Evidence

Paragraph 18 – The original proposed standard included a description that "[w]ritten confirmations might be received in paper form, or by electronic or other medium." We note that this description is excluded from the reproposed standard. While we understand the PCAOB is in the process of considering amendments to its interim standard, AU 330, *The Confirmation Process*, we are concerned that the removal of the expectation that confirmations be "written," could have an effect on the auditor's evaluation of information provided from third parties as part of the audit. For example, the paragraph as currently drafted could be interpreted to pertain equally to oral responses to oral requests for information, which we do not believe is the Board's intent. As such, we recommend that the Board consider re-inserting the word "written" in the first sentence so it refers to a "direct written response." We believe such language would better maintain the existing guidance until the completion of the Board's current project on confirmations.

In summary, we appreciate the effort and time the Board and its staff have devoted to this proposal, and its careful consideration of our comments. While we believe the reproposed standards represent a significant improvement over the original proposal, we believe they require more consideration with respect to the areas outlined above.

We appreciate the opportunity to comment on the reproposed standards and would welcome the opportunity to respond to any questions you may have regarding any of our comments and recommendations. If you have any questions on our response please contact Erica Forhan in our Professional Practice Group at 206-302-6826 or Erica.Forhan@mossadams.com.

Very truly yours,

Moss Adams LLP

Moss Adams LLP

new york state society of
NYSSCPA
certified public accountants

Home of the Trusted Professional
3 park avenue, at 34th street, new york, ny 10016-5991
212.719.8300 • fax 212.719.3364
www.nysscpa.org

February 26, 2010

Mr. Keith Wilson, Associate Chief Auditor
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

By e-mail: comments@pcaobus.org

**Re: PCAOB Release No. 2009-007 – Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards
(PCAOB Rulemaking Docket Matter No. 026)**

Dear Mr. Wilson:

The New York State Society of Certified Public Accountants, representing 28,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the above captioned release.

The NYSSCPA's SEC Practice Committee and Auditing Standards Committee deliberated the release and prepared the attached comments. If you would like additional discussion with us, please contact Anthony S. Chan, Chair of the SEC Practice Committee at (212) 331-7653, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

David J. Moynihan
President

Attachment

new york state society of
NYSSCPA
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Home of the Trusted Professional
3 park avenue, at 34th street, new york, ny 10016-5991
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COMMENTS ON

PCAOB RELEASE NO. 2009-007 – PROPOSED AUDITING STANDARDS RELATED TO THE AUDITOR'S ASSESSMENT OF AND RESPONSE TO RISK AND RELATED AMENDMENTS TO PCAOB STANDARDS

(PCAOB RULEMAKING DOCKET MATTER No. 026)

February 26, 2010

Principal Drafters

From the SEC Practice Committee:

David Bender
Anthony S. Chan
Peter J. Pirando
Theo Vermaak

From the Auditing Standards Committee:

Kamel Abouchacra
Vincent Gaudiuso
Menachem Halpert
Jan C. Herringer
Julian Jacoby, *Advisor*
Michael E. Kayser
Moshe S. Levitin
Mark Mycio
Bernard H. Newman
John C. Parcell IV
William J. Prue
Michael A. Sabatini
Richard T. Van Osten
Robert N. Waxman

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Comments on

PCAOB Release No. 2009-007
Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards

(PCAOB Rulemaking Docket Matter No. 026)

We welcome the opportunity to respond to the Public Company Accounting Oversight Board's ("PCAOB") *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (the "New Proposed Standards"). On balance, we believe that the New Proposed Standards are well written, and we do not anticipate any significant implementation issues as they are properly aligned with PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

We begin our response with comments on convergence. The balance of the letter is organized in the following order, presenting specific comments on each proposal followed by answers to the questions posed in Appendix 9, *Additional Discussion*.

A. Audit Risk
B. Audit Planning and Supervision
C. Consideration of Materiality in Planning and Performing an Audit
D. Identifying and Assessing Risks of Material Misstatement
E. The Auditor's Responses to the Risks of Material Misstatement
F. Evaluating Audit Results
G. Audit Evidence

Convergence of Auditing Standards

We support the Board's consideration of the work of other standard setters. We recognize that the Board may decide that different procedures are appropriate in the U.S. public company audit context, and, therefore, we encourage the Board to continue to minimize the differences in its standards to only those matters that are particular to audits of issuers in the U.S. Such a practice would result in highlighting the different procedures required in the U.S. public company audit context and improve the understanding of the PCAOB standards.

Minimizing differences allows firms, for example, to cultivate synergies related to training, implementation, and the development and maintenance of quality control systems that accommodate the standards of the various standard-setting bodies (all factors that we believe efficiently contribute to enhanced audit quality).

Additional Discussion of Topics

Question 1. **Are the objectives in the new proposed standards useful in providing context for the requirements in the standards?**
Yes.

A. Audit Risk

Specific Comment**:**
Paragraph, 7b defines control risk as "… the risk that a misstatement due to error or fraud that could occur in an assertion and that could be material, individually or in combination with other misstatements, will not be prevented or detected on a timely basis by the company's internal control." To align this closer to the International Auditing and Assurance Standards Board **(**IAASB) and Auditing Standards Board (ASB) definition and to clarify that controls are designed to result in correction of detected misstatements, we suggest the insertion of the word "corrected" in the sentence—"…will not be prevented, or detected and corrected, on a timely basis..."

Questions:
2. **Does the new proposed standard on audit risk describe clearly the concept of audit risk and its components?**
Yes.

3. **Does the new proposed standard on audit risk describe clearly the relationship between detection risk and substantive procedures?**
Yes. We agree that it does.

B. Audit Planning and Supervision

Specific Comments:
1. Paragraph 3 describes the responsibility of the engagement partner for planning and supervision of the audit. However, the description does not consider the circumstance, which may be common in multi-location audits when there is more than one engagement partner and, as such, we recommend clarifying the responsibility of the engagement partners in such a circumstance.

2. Paragraphs 11 and 12 (multi-location engagements) refer to "consolidated" financial statements in a manner that is inconsistent with the terminology as used elsewhere in the standards. Although these paragraphs deal with multiple locations, they may be business divisions that do not meet the definition of "consolidation." We suggest the removal of the word "consolidated."

3. Paragraph 14 refers to paragraph 5 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, and provides a summary of the guidance relating to audits of multi-location entities. However, the summary only includes one aspect of introducing unpredictability in auditing procedures, and does not seem to be specific to a multi-location engagement. The paragraph states that the "auditor should vary the nature, timing, and extent of audit procedures at locations or business units from year to year" whereas we believe it would be more appropriate within the context of multi-location engagements to discuss the concept of unpredictability in terms of varying the location where audit procedures are to be performed.

4.. Paragraph 15 describes the circumstances when the auditor should modify the overall strategy and audit plan and includes matters such as a revised assessment of the risk of material misstatement or the discovery of a previously unidentified risk of material misstatement. We recommend including the concept of "changes to planning materiality" as another example of such a circumstance.

5. Paragraph A2 defines the term "engagement partner" as a member of the engagement team with primary responsibility for the audit. We recommend having this definition conform to Auditing Standard No. 7, *Engagement Quality Review,* which defines the term as "The member of the engagement team with primary and final responsibility for the audit."

Questions:
4. **Are the proposed requirements for multi-location engagements appropriately aligned with Auditing Standard No. 5?**
We believe the proposed requirements are appropriately aligned with Auditing Standard No. 5, except for the item noted below, relating to paragraph 14.

5. **Is it clear how the proposed requirements for multi-location engagements would be applied in audits of financial statements only?**
Yes, the proposed requirements clearly describe how the multi-location guidance would be applied in audits of financial statements only.

6. **Are the differences between the responsibilities for supervision of engagement team members and oversight of specialists in accordance with AU sec. 336 appropriate in light of the auditor's responsibilities to opine with reasonable assurance on whether the financial statements are fairly presented, in all material respects, in conformity with the applicable financial reporting framework?**
Yes, the differences between the responsibilities for supervision of engagement team members and oversight of specialists is appropriate. We believe that the engagement partner should be responsible for the supervision of all engagement team members, including those with specialized skill and knowledge, whether engaged or employed by the auditor, and recognize that in carrying out this responsibility with respect to the oversight of specialists, specific oversight procedures are necessary. As such, we support the Board's standard setting project to review AU sec. 336, *Using the Work of a Specialist*, to address the auditor's use of specialists.

C. Consideration of Materiality in Planning and Performing an Audit

Specific Comments:
1. Paragraph 2, quotes TSC Industries v. Northway, Inc., saying a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." … See also Basic, Inc. v. Levinson ….
   TSC Industries Inc. v. Northway Inc. is a case which concerned the omission of certain facts from a proxy statement. The quote used in the proposal is incomplete, and as such we believe is taken out of context since it does not address omitted facts. The full quote follows:
   > "…a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact

would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

With respect to Basic, Inc. v. Levinson, l the court "adopted, for the §10(b) and Rule 10b-5 context, the standard of materiality set forth in *TSC Industries, Inc. v. Northway, Inc. ...."* We believe the definition of materiality with reference to the U.S. Supreme Court is inappropriate as it might impact auditor liability and increase litigation risk. Because the definition does not appear dissimilar from that of SAB 99, *Materiality*, (in which the SEC described the qualitative aspect of materiality as that of any matter important to the reasonable reader of financial statements), we question why reference to the Supreme Court case is necessary and suggest removal of this reference. If the Board does not follow this suggestion, we recommend that the complete quote from TSC be used in the final standard.

2. Paragraph 6. When planning the audit, the auditor should establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This includes consideration of the company's earnings and other relevant factors. To determine the nature, timing, and extent of audit procedures, the materiality level for the financial statements as a whole needs to be expressed as a specified amount. So that auditors do not focus on the use of "earnings" as the materiality measuring stick, we recommend that "other relevant factors" be expanded to give examples of other factors that may require consideration. Such other relevant factors include (a) net revenues, (b) financial position totals (c) account balances, and (d) the trend from year to year of these benchmarks. Additionally, we believe the Standard should also discuss the consistency of the benchmark used to determine materiality from year to year and the documentation for the reasons for any changes in the benchmark.

3. Paragraph 8. Accordingly, the amount or amounts of tolerable misstatement should be less than the materiality level for the financial statements as a whole and, if applicable, the materiality level or levels for particular accounts or disclosures. This last sentence appears to be a third level of materiality; we therefore recommend that this paragraph clearly indicate the materiality thresholds auditors should consider.

4. Paragraph 9. In determining tolerable misstatement and planning and performing audit procedures, the auditor should take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods. We recommend that the Standard clarify this paragraph by saying "…and amount of both corrected and uncorrected misstatements…."

5. Paragraph 11(b). The financial statements used in establishing the materiality level or levels and in determining tolerable misstatement have changed significantly, e.g., because significant adjustments to the financial statements would result in a lower amount for the materiality level or levels or tolerable misstatement. This situation is addressed in the proposal Evaluating Audit Results (paragraph 16) which says:

   Note: If the reassessment of materiality as set forth in paragraphs 11-12 of Proposed Auditing Standard, Consideration of Materiality in Planning and Performing an Audit, results in a lower amount for the materiality level, the auditor should take into account that lower materiality level in the evaluation of uncorrected misstatements.

   We therefore propose providing a cross reference from paragraph 11(b) to this paragraph.

General Comments:
We believe that this auditing standard is not sufficiently robust (lacking implementation guidance) to guide auditors in establishing levels of procedures which will would provide sufficient appropriate evidence to support audit opinions. One of our primary concerns we have is that the standard ignores the distinction between accounting materiality and audit materiality, by not discussing these terms (and their use) separately. Audit materiality (also known as performance materiality and planning materiality) is the maximum value of any undetected misstatement given the maximum acceptable risk (the maximum risk the auditor is willing to accept). For example, if overall audit risk expressed in a percentage is 10% and materiality is $100,000, audit scope would be designed to yield no more than a 10% risk of detecting misstatement in excess of $100,000.

Audit materiality is used in three ways: (1) as a scope determinant for sampling applications,(2) as a limit on untested population (if untested population is larger than materiality it could contain material misstatement), and (3) as the judgmentally determined amount over which an analytical procedure designed to be used as a primary substantive test would identify misstatement. Paragraphs 7 and 8 imply that tolerable error determination should be less than materiality as discussed in paragraph 6. We agree that the (accounting) materiality should be a sensitized user/investor driven value and consequently a small value relative to any entity's financial statements. A relatively small number as a starting point for the determination of tolerable error is unworkable. Sampling procedures use tolerable error as a determinant of sampling precision. Tolerable error should be an amount which is three to four times larger than accounting materiality to be able to include sampling precision (the difference between upper error limit and projected error). Projected error on sampling tables extrapolate quickly so that upper error limits are at least three times projected error in most circumstances.

We believe a consideration of sampling precision both in the planning phase and the evaluation phase (for substantive testing procedures) is necessary. Audit risks, entity size considerations, and user considerations can be built into benchmarking concepts that underpin sampling methodologies, with user considerations emphasized, for audit planning materiality determinations. Once the desired sampling precision (both overall and at the assertion/test levels) is determined, than the audit tests can be appropriately evaluated and measured for effectiveness. The proposed standard fails to deal with these elemental concepts.

To quote Leslie, Teitelbaum, and Anderson (1979). *Dollar Unit Sampling – A Practical Guide for Auditors,* (1979), "…a materiality limit for an individual audit engagement has two uses: as a guide to audit planning (design and extent of verification procedures) and as a guide to evaluation of audit results (the formation of an audit opinion)." This is particularly important in the use of sampling." ***And sampling is at the heart of what auditors do*** (our emphasis).

Questions:
7. **Are the provisions in the new proposed standard regarding consideration of materiality in multi-location engagements appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?**
Yes, we believe the proposed revisions are appropriate.

8. **Are the revised provisions regarding reassessment of materiality appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that,**

individually or in combination, would result in material misstatement of the financial statements?

Yes, we believe the proposed revisions are appropriate. However, some of the language in paragraph 11 is possibly too restrictive. For example, the auditor is required to "reassess the established materiality level or levels and tolerable misstatement," but the reason listed implies that only materiality by definition (i.e., that which would influence reasonable investors) would need to change. The reason listed is "because of changes in the particular circumstances or additional information that comes to the auditor's attention, there is a substantial likelihood that misstatements of amounts that differ significantly from the materiality level or levels that were established initially would influence the judgment of a reasonable investor." We believe this reason should be expanded or made less restrictive. Presumably tolerable misstatement could change without materiality changing the auditor's risk assessment as a particular area changes.

D. Identifying and Assessing Risks of Material Misstatement

Specific Comments:

1. Paragraph 4. "The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of the risks of material misstatement due to error or fraud (footnote omitted) and to design further audit procedures. 4/"

   We suggest adding to this sentence the underlined "…and to design further audit procedures focused on the areas of greatest risk."

2. The phrase "design further audit procedures" is used in paragraphs 18 and 33. Those paragraphs should reference back to footnote 4.

3. Note [one] in paragraph 10 says: "The size and complexity of a company might affect the risks of misstatement and how the company addresses those risks." However, this note does not provide any additional guidance about auditing in the smaller company environment. Additionally, the Note to paragraph 17 also does not provide any additional insights into the procedures to perform in the smaller company environment. This paragraph states, "Smaller companies might have less formal processes to measure and review financial performance. In such cases, the auditor might identify relevant performance measures by considering the information that the company uses to manage the business." We recommend revising these notes to provide specific guidance in the application of:

   Note [two] to paragraph 10: "The auditor should take into account the information gathered while obtaining an understanding of the nature of the company when determining the existence of related parties, in accordance with AU sec. 334, Related Parties." We suggest revising this note as follows "The auditor should take into account the information gathered while obtaining an understanding of the nature of the company to determine ~~when determining~~ the existence of related parties…."

4. Paragraph 12, third bullet says "The accounts or disclosures in which judgment is used in the application of significant accounting principles, especially in determining management's estimates and assumptions." We recommend adding a step to say that auditors compare prior years estimates and assumptions to this year's actual results (for example, the estimated

allowance for inventory obsolescence compared to amounts actually sold below cost, scrapped, etc.) to determine the risks related to such estimates and assumptions.

This point may also be related to paragraph 15, fifth bullet: "Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated.)"

5. Paragraph 36 should be clarified by removing the first sentence:
6. The preceding paragraphs discuss the auditor's responsibilities for obtaining an understanding of internal control as part of performing risk assessment procedures. The objective of obtaining an understanding of internal control, (as discussed in paragraph 18), is different from testing controls for the purpose of assessing control risk 17/ or for the purpose of expressing an opinion on internal control over financial reporting in the audit of internal control over financial reporting.
7. We recommend expanding the Note to paragraph 45 as follows: "Analytical procedures performed as risk assessment procedures often use data that is preliminary or data that is aggregated at a high level and ordinarily are not designed with the level of precision necessary for substantive analytical procedures."
8. We believe that footnote 22 (to paragraph 46) is important enough to be included in the body of the standard. This example should then be referenced to paragraph 68.
9. Paragraph 56(d): "Assess the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements." We believe the term "likelihood" should be defined in terms of reasonable possibility as that term is used in AS 5 paragraphs 63-65.

Questions:

9. **Does the new proposed standard adequately describe the auditor's responsibilities for performing risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of risks of material misstatement due to error or fraud and to design further audit procedures?**

Yes, we believe the responsibilities are adequately described.

10. **Are the auditor's responsibilities regarding the additional procedures for understanding the company and its environment in paragraph 11 clear?**

Yes.

11. **Are the proposed requirements regarding obtaining an understanding of internal control over financial reporting appropriate in light of the auditor's responsibilities for identifying and assessing the risks of material misstatement?**

Yes, we believe the proposed requirements are appropriate.

12. **Are the proposed requirements regarding the discussion among engagement team members about risks of material misstatement appropriate given the auditor's responsibilities for identifying and assessing the risks of material misstatement?**
Yes.

E. The Auditor's Responses to the Risks of Material Misstatement

Specific comments:

1. There is some inconsistent terminology. For example, paragraph 41 states, "The auditor's substantive procedures must include the following…", while "should" is used elsewhere to indicate requirements.

2. The document is silent on the response to identified information technology general control ("ITGC") risks. IT risk assessment is discussed in Appendix B - Consideration of Manual and Automated Systems and Controls of Appendix 4 (pageA-4, paragraph 32). However, consideration of how IT processing may introduce specific risks relating to fraud or error occurring in the financial statements and the response to such risks should be mentioned in Appendix 5. For example, IT processing may introduce threats to data integrity, threats from hackers to system security, inappropriate access to restricted or sensitive data or ability to adjust records or post fraudulent entries and theft of financial and sensitive information.

3. Appendix 5 is silent on using the work of experts (specialists) as it relates to responding to identified risks. Appendix 7 on Audit Evidence discusses AU 336, but it might be helpful to also discuss it in Appendix 5 and refer to Appendix 7 for more detail.

4. There is very little reference to Entity-level controls ([it's only mentioned one time) and possible reliance when the entity-level controls operate at a level of precision to achieve control objectives at the assertion level, which is especially meaningful for smaller companies who face segregation of duties issues and such entity-level monitoring controls are the only compensating controls that may exist.

5. Paragraph 5(b). The reference to Audit Planning and Supervision should be included in a footnote.

6. Paragraph 5(c). Examples of ways to incorporate an element of unpredictability are (a) performing audit procedures related to accounts, disclosures and assertions that would not otherwise be tested based on their amount or the auditor's assessment of risk; … (c) selecting items for testing that have lower amounts or are otherwise outside customary selection parameters….

   The Board should clarify the difference between (c) "… outside selection parameters…, and (a)…"would not otherwise be tested…."

7. Paragraph 6. Examples of such pervasive changes include performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence. We recommend eliminating the examples and reference paragraphs 39-46 of the Proposal in a footnote.

8. Paragraph 22. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation and re-performance of the control. The Board should also consider further expanding this listing of procedures to include computer assisted audit techniques ("CAATs").

9. Paragraph 23. Note: To obtain evidence about whether a control must be tested directly…. The Board should consider clarifying this. We believe that the audit team can continue to rely on internal audit and the work of others for the testing of certain controls if the auditor can determine that the work of others is performed by competent and objective personnel.

10. Paragraph 24. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control.

    Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.

    In addition to inquiry, we believe that observation alone does not support a conclusion about the effectiveness of a control. Inquiry and observation can be performed in tandem to possibly support the conclusion depending on the nature of the control being tested; i.e., to verify that policies and procedures have been established, an auditor can inquire of appropriate management personnel and observe a copy of the relevant policies and procedures manual.

11. Paragraph 27, fourth bullet: "The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control."

    Paragraph 39, "Substantive procedures generally provide persuasive evidence when they are designed and performed to obtain evidence that is relevant and reliable."

    Paragraph 39, Note: Proposed Auditing Standard, Audit Evidence, provides more direction regarding the types of substantive procedures and the relevance and reliability of audit evidence.

    Paragraph 42. "However, increasing the extent of an audit procedure cannot adequately address an assessed risk of material misstatement unless the evidence to be obtained from the procedure is <u>reliable and relevant</u>."

    The term "appropriateness" (or "appropriate") should be used in place of relevance and reliability in the above quotes to conform to its use in paragraphs 7 and 17 in the proposal, and its definition in the Audit Evidence proposal at paragraph 6 which says, "Appropriateness is the measure of the quality of audit evidence, i.e., its relevance and reliability."

12. Paragraph 30 states: The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors:

    An added bullet is required, which states:

    The client company should maintain documentation of all changes in internal controls introduced during the period under audit. That documentation should be available to the auditor.

13. Paragraph 44. In determining whether it is appropriate to perform substantive procedures at an interim date, the auditor should take into account the following:

The first item, a, should have an additional point: (3) A review of the internal control changes that have been made to date and the nature and extent of monitoring such changes by the client's staff.

Also consider adding a bullet point to include when the controls are designed or operating effectively.

Questions:

13. **Are the proposed requirements for overall responses and responses involving the nature, timing, and extent of audit procedures appropriate given the auditor's responsibility to opine with reasonable assurance about whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?**

Yes.

14. **Does the new proposed standard clearly describe when tests of controls are necessary in an audit of financial statements only?**

Yes.

F. Evaluating Audit Results

Specific comments:

1. Paragraph 4(e): The presentation of the financial statements, including disclosures;
   We suggest the following revision, "The presentation of the financial statements, including disclosures and omitted disclosures," or alternatively "including the required disclosures." This revision would then conform to paragraph 31 which says "…the auditor should evaluate whether the financial statements contain the required disclosures."

2. Paragraph 5. In the overall review, the auditor should read the financial statements and disclosures and perform analytical procedures to (a) assess the auditor's conclusions formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement.
   The auditor's standard report does not mention "financial statements as a whole" and paragraph 17 discusses the need to evaluate uncorrected misstatements in relation to the accounts and disclosures and to the financial statements as a whole (giving consideration to quantitative and qualitative factors). Further, paragraph 34(a) observes that the "significance of uncorrected misstatements and likelihood of their having a material effect, individually or in combination on the financial statements" does not discuss "financial statements as a whole." For those reasons we believe that Par. 5(b) should read "assist in forming an opinion on whether the financial statements as a whole are free of material misstatement.

3. Paragraph 13. If the auditor concludes that the amount of an accounting estimate included in the financial statements is unreasonable or was not determined in conformity with the applicable accounting principles....
   We suggest that "applicable accounting principles" be differentiated from "applicable financial reporting framework" used elsewhere in the proposals, or change the former to the latter.

4. Paragraph 18. The auditor's evaluation of uncorrected misstatements, as described in the preceding paragraph, should include evaluation of the effects of uncorrected misstatements

detected in prior years and misstatements detected in the current year that relate to prior years.
For greater clarity, we recommend that this standard use the terms “rollover” and “iron curtain” as those terms are used in Staff Accounting Bulletin 108 (Topic 1, Section N of the SABs).

5. Paragraph 34(e). The relevance and reliability of the audit evidence obtained.
The proposal on Audit Evidence, at paragraph 6, says “Appropriateness is the measure of the quality of audit evidence, i.e., its relevance and reliability. To be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor’s opinion is based.” We therefore suggest that subparagraph (e) be revised to read “The appropriateness (i.e., the relevance and reliability) of the audit evidence obtained.”

6. Paragraph 35. … If the auditor is unable to obtain sufficient appropriate audit evidence to have a reasonable basis to conclude about whether the financial statements as a whole are free of material misstatement ….
See the discussion under Item 2 regarding paragraph 5.

7. Appendix B2. (a). The potential effect of the misstatement on trends, especially trends in profitability.
“Profitability” is not a defined term. We suggest this sentence be clarified and changed to read:
> The potential effect of the misstatement on trends, especially trends in profitability, for example, (a) gross profit, earnings before taxes, earnings after taxes, and (b) profitability as measured against other companies in the same or a similar industry.

Questions:
15. **Does the new proposed standard clearly describe the auditor’s responsibilities for accumulating and evaluating misstatements?**
We believe that the proposed standard clearly describes the auditor’s responsibilities for accumulating and evaluating misstatements. However we believe the standard could be improved with additional guidance on corrected audit adjustments. The proposed standard appropriately considers (in paragraph 34) that significant uncorrected misstatements need to be considered in reaching a conclusion that sufficient appropriate evidence has been obtained to support the auditor’s opinion.

We believe that significant corrected adjustments also should be considered in reaching this conclusion. For example, if a high level of audit adjustments were identified during the audit, this is a factor that should be considered in determining the level of audit evidence required. A material corrected misstatement, or several material corrected misstatements, could indicate that the auditor’s understanding of the client and its control environment, obtained during the planning phase of the engagement, may be incorrect and that the scope of the audit procedures should be reassessed.
We therefore suggest that the factors in paragraph 34 be expanded to include some discussion about the effect of corrected misstatements on whether sufficient appropriate audit evidence has been obtained by the auditor.

16. **Does the new proposed standard appropriately describe the auditor’s responsibilities for evaluating the presentation of the financial statements, including evaluating bias, in light of the**

auditor's responsibility to opine with reasonable assurance on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?
We believe the proposed standard appropriately describes the auditor's responsibilities for evaluating the presentation of the financial statements, including evaluating bias, in all material respects, in conformity with the applicable financial reporting framework.

G. Audit Evidence

Specific comments:

1. Paragraph 2. Audit evidence is all the information, whether obtained from audit procedures or other sources that is used by the auditor in arriving at the conclusions on which the audit opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and any information that contradicts such assertions. It is unclear whether the last phrase, "and any information that contradicts such assertion," means the auditor should look for such contradictory information, or applies only if such information comes to the attention of the auditor. If auditors should proactively look for such evidence, then the standard should provide guidance as to the procedures that should be followed to discover this conflicting evidence. Further, we recommend that this discussion be referenced to paragraph 29.

2. Paragraph 7a. The relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The relevance of audit evidence depends on:

   a. The design of the audit procedure used to test the assertion or control, in particular whether it is designed to (1) test the assertion or control directly, and (2) test for understatement or overstatement.

   We recommend the proposed standard should be revised to reflect a more expanded description of what relevance is. The redrafted AICPA audit standard on audit evidence provides the following in its paragraph A28-

   > "Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, when appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing. For example…"

3. Paragraph 8. The third bullet in paragraph 8 states, "Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly." Because the proposed standard does not explain the term "indirectly," the committee believes the proposed standard should provide examples of the types of evidence that are obtained directly and the types of evidence that are obtained indirectly. The fourth bullet in paragraph 8 states, "Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized, or otherwise converted into electronic form, *the reliability of which depends on the controls over the conversion and maintenance of those documents*". [Emphasis added.]

   If the purpose of the last sentence in this paragraph is to suggest that effective internal control could cause evidence from non-original documents to be considered reliable, then, in the Committee's opinion, the first sentence in that paragraph, which states that evidence from non-original documents, is not as reliable as evidence from original documents appears to contradict this position. We, however, believe that if there are proper controls over the conversion process, there should be no difference in the perceived reliability between original documents and converted documents. As technology progresses, more and more documentation will take electronic form. Paper documentation will increasingly become an archaic practice of the past. “Original documents” might, in fact, be electronic from the start, and never be “converted.” In this instance, it is not clear from the standard how reliable this evidence would be. Furthermore, because auditors were never document experts to begin with, the audit profession’s historical practice of attributing unquestioned reliability to physical documentation was never justified. We believe that electronic information, subject to the proper controls, is in many ways more reliable than physical documentation. We believe the standard should be revised to acknowledge this reality.

4. Paragraph 12. The auditor may base his or her work on assertions that differ from those in this standard if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement in each significant account and disclosure that have a reasonable possibility (footnote omitted) of containing misstatements that would cause the financial statements to be materially misstated.

   We recognize this exact same language is in par. 28 of AS 5; however, the meaning of this paragraph is unclear. What assertions are not encompassed by the five assertions in the proposal? We believe additional guidance or examples are needed to explain the significance of this paragraph.

5. Paragraph 15. Paragraph 15 states - Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.

   We believe that it is not enough for such controls to be effective, but that they also need to be properly designed. The standard should state this.

6. Paragraph 17. Note: Inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.

   We recommend that this Note read as follows:

   > Inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the <u>design and operating</u> effectiveness of a control.
   >
   > Further, we recommend that this Note be revised to include the AICPA’s standard (at AU 326.35):
   >
   > > “The auditor should perform audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Inquiry alone ordinarily does not provide sufficient appropriate audit evidence to detect a material misstatement at the relevant assertion level.”

7. Paragraph 28. Audit sampling is the application of an audit procedure to less than 100 percent of the occurrences of a control or items comprising an account for the purpose of evaluating some characteristic of the control or account.

   We recommend that this definition conform to AU 350 which defines audit sampling as follows:

   > "Audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class (footnote omitted)."

Question:
17. **Does the new proposed standard describe clearly how the auditor should determine the financial statement assertions to use for both integrated audits and audits of financial statements only?**
Yes, the proposal provides a cross-reference to AS 5 in footnote 1, but not to the relevant paragraphs (pars. 28-33).

Proposed Amendments to Interim Ethics Standards

Question:
18. **Are there provisions in the to-be-superseded standards that should be retained?**
No.

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PricewaterhouseCoopers LLP
400 Campus Dr.
Florham Park NJ 07932
Telephone (973) 236 4000
Facsimile (973) 236 5000
www.pwc.com

March 2, 2010

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 026, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* and *Related Amendments to PCAOB Standards*

Dear Sir:

We appreciate the opportunity to respond to the Public Company Accounting Oversight Board's (PCAOB or the "Board") *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* and *Related Amendments to PCAOB Standards* (the "standards," "proposed standards" or "proposals").

We fully support the Board's objective to update its interim standards regarding risk assessment. Identifying, assessing and responding to risks are integral to the audit process and fundamental to the conduct of high quality, effective and efficient audits. We believe that the proposed standards are significantly improved. For example, appropriate linkage between assessed risk and auditor's response has been added; alignment with Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AS 5) has been improved; enhancements were made in the consistency of the usage of terminology; and overall organization is generally enhanced. We appreciate the Board's responsiveness in considering, addressing and providing feedback on comments received on the original proposal.

We also commend the Board for reexposing these proposed standards, particularly given that these standards provide the foundation for all audits and, additionally, will provide a basis for the Board's future standard setting activity.

While appreciative of the improvements from the original draft, we have concerns about certain provisions in the reexposed proposals. In the remainder of our letter, we have organized our overall observations and concerns about the proposal into the following topical areas:

- Increased integration with AS 5
- Overarching observations and recommendations on the standard setting process
- Effective date

Finally, we have included our specific comments for each of the proposed standards and the conforming amendments in the Appendix to this letter.

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Increased Integration with AS 5

We believe that the Board has made significant improvements with respect to aligning guidance in the proposed standards with that in AS 5. In particular, we believe that the Board has appropriately eliminated from the proposals certain guidance that is relevant only to an integrated audit. In addition, we agree with the incorporation of additional guidance from AS 5 on multilocation engagements (in paragraphs 11-13 of proposed standard *Audit Planning and Supervision)* and identifying significant accounts and disclosures and their relevant assertions (in paragraphs 57-61 of proposed standard *Identifying and Assessing Risks of Material Misstatement)*.

We have some concern, however, about the manner in which some guidance from AS 5 has been incorporated into the proposed standards, as further described below.

Identifying and Assessing Risks of Material Misstatement

At paragraphs 62-65 of the proposed standard, the Board has included a new subsection, "Understanding Likely Sources of Misstatement," from paragraphs 34-38 (omitting paragraph 35) of AS 5. Paragraph 62 requires the auditor to achieve various objectives to further understand the likely sources of potential misstatements, including a requirement to identify the controls management has implemented to address potential misstatements. Moreover, paragraph 64 describes walkthroughs as frequently being the most effective way of achieving the objectives of paragraph 62. Walkthroughs are described as consisting of following transactions from origination to a company's financial records, usually using a combination of inquiry (including probing questions), observation, inspection of relevant documentation, and reperformance of controls.

In AS 5, the required understanding is used to inform the auditor's selection of the controls to test and also constitutes procedures that result in obtaining evidence regarding the effectiveness of controls. In a financial statement audit only (i.e., one that is not integrated with an audit of internal control over financial reporting), however, the auditor may elect to use a substantive approach and therefore decide not to rely on certain controls. In such circumstances, we are concerned that aspects of the requirements in paragraphs 62 and 64-65 may be interpreted as requiring the testing of controls for effectiveness even when the auditor does not plan to rely on such controls. Such extension of auditor responsibility would add unnecessary cost without a corresponding increase in audit quality. We believe the Board should either delete paragraph 62 or make it applicable only in relation to controls the auditor plans to test.

If the Board decides to retain paragraph 62, we believe the Board should consider how the first objective, which is to "Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded," is distinguished from the objective of paragraph 28 subparagraphs (a) and (b) which require the auditor to obtain an understanding of "the classes of transactions in the company's operations that are significant to the financial statements" and "the procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported." We believe that it may be confusing to retain paragraph 62 in its current form rather than integrate it with the requirements in paragraph 28.

We believe that the Board should retain paragraph 63, which requires the auditor to understand how information technology affects the company's flow of transactions, even if paragraph 62 is removed. We recommend, however, moving paragraph 63 to follow paragraph 28 of the proposed standard. We also recommend moving the presumptively mandatory requirements out of Appendix B and into paragraph 63 as we continue to believe that placing presumptively mandatory requirements in the text of the standard heightens their visibility.

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Lastly, we recommend the Board consider moving the guidance in paragraphs 64-65 on performing walkthroughs to follow paragraph 20, and making the following changes: (1) changing the first sentence of paragraph 64 to state that walkthroughs may be performed in connection with obtaining an understanding of internal control, (2) stating that walkthroughs ordinarily are sufficient to evaluate design effectiveness and to establish that controls have been implemented, and (3) deleting the references to walkthroughs in the Notes in paragraphs 19 and 20.

The Auditor's Responses to the Risks of Material Misstatement

The Board has revised paragraph 31 of this proposed standard to incorporate from AS 5 additional factors that the auditor should take into account in determining the evidence needed during the current year audit to support the auditor's control risk assessments. The second sentence of this paragraph establishes a presumptively mandatory requirement for the auditor to take these fifteen factors into account when controls have been tested in past audits. We believe this requirement should apply *only* when the auditor intends to use evidence obtained from tests of controls in prior year audits in the current year audit. Finally, we recommend that the Board revise paragraph 31 to incorporate the guidance from paragraphs 57 and 59 of AS5 which allows the auditor's experience in prior years to inform its assessment of risk, which in turn affects the nature, timing, and extent of testing necessary.

Overarching Observations and Recommendations on the Standard Setting Process

Convergence of Auditing Standards

As discussed more fully in our February 18, 2009 comment letter on the original proposal, we continue to support the Board's consideration of the work of other standard setters, including the International Auditing and Assurance Standards Board (IAASB) and the AICPA's Auditing Standards Board (ASB). We continue to believe that increased convergence of high-quality auditing standards has the potential to elevate the consistency of the quality of audits performed worldwide, including those performed in accordance with the PCAOB's standards. Accordingly, we continue to encourage the Board to avoid creating unnecessary differences between its standards and the International Standards on Auditing (ISAs), introducing differences only when necessary for audits, including integrated audits, of issuers.

Although significant differences remain, we recognize that the proposed standards are more closely aligned with the IAASB's ISAs than the prior proposal, and we commend the Board's efforts in this regard. We also commend the Board for including the commentary comparing its proposed standards and the ISAs. Such analysis provides useful insight to the Board's rationale for such differences. We encourage the Board to continue this practice. However, we urge the Board to participate in the work of, and engage with, other standard setting bodies so that collectively plans can be developed to eliminate unnecessary differences. We believe that a collaborative approach among standard setters will facilitate convergence and that such an approach can enhance the effectiveness of all standard setters involved.

Transparency in the Standard Setting Process

We believe the Board has taken important steps to improve the transparency of its standard setting process, most notably its recent use of concept releases to elicit earlier public input and its reexposure of proposals.

We also see positive signs of increased transparency within the proposed standards, including more in-depth discussion of constituent comments and their disposition, and enhanced commentary comparing the proposal with the ISAs. We appreciate these efforts and, consistent with Chairman Daniel L. Goelzer's comments at the December 17, 2009 open meeting, we urge the Board "to continue to explore ways of making its standard setting - and the thinking that underlies its proposals - more open." We encourage the Board to address in particular the matters discussed below.

1) *Nature, Timing and Extent of Public Involvement in the Standard Setting Process*

We acknowledge the important role that the Board's Standing Advisory Group (SAG) and its inspection process play in informing the Board's agenda. We also acknowledge and encourage the Board's recent efforts to increase the depth and accelerate the timing of public involvement, including the auditing profession, in providing input to its standard setting process. We believe that this can be done transparently and effectively without compromising the independence of the standard setting process. As an example, we encourage the Board to establish external task forces, consisting of members of the auditing profession, investors, academics, and other relevant parties, to participate in developing new standards. This could provide the Board with an opportunity to obtain public input during the development stage of a standard, prior to its release for public comment. We believe that such a process would enhance the quality, timeliness and efficiency of the development process and complement the role of the SAG and the other forums that currently inform the Board's standard setting activities.

2) *Use of Release Text to Provide Guidance*

In some situations, it appears that the Board is providing application guidance and interpretations in the release that accompanies the final standard. Interpreting standards through release text can result in potential confusion over the intent of the requirements within the related standard. In addition, because the release is not ultimately part of the final standard (i.e, not part of the "Rules of the Board" that are approved by the SEC), it is important that guidance considered necessary to understand the requirements of the standard be included in the standard. For example, we believe that certain content from the Board's commentary in Appendix 9, shown below in italics for identification, relating to the proposed conforming amendments to AU 350, *Audit Sampling*, should be included in the standard.

> The original proposal included amendments to AU secs. 350.23 and 350.38, which would explain more specifically how the principles in the standard for determining sample sizes when nonstatistical sampling approaches are used. Some commenters expressed concerns that the proposed amendments would have required auditors who use nonstatistical sampling methods to compute sample sizes under both statistical and nonstatistical methods to demonstrate that the sample size under the nonstatistical method equaled or exceeded sample size under a statistical method. *The proposed amendments are not intended to require auditors to compute sample sizes using statistical methods in all instances to demonstrate compliance with the requirements. For example, the use of a nonstatistical sampling method that is adapted appropriately from a statistical sampling method also could demonstrate compliance* (italics added). Accordingly, these amendments are retained as originally proposed.

In order to incorporate the above interpretive guidance into the standard, and as stated in our February 18, 2009 comment letter on the Board's prior proposal, we recommend that the Board restore footnote 5 from extant AU 350 at the end of paragraph 23A of the proposed conforming amendments to AU 350, and additionally include a footnote reference at the end of paragraph 38 referring back to that footnote. Footnote 5 states "This guidance does not suggest that the auditor using nonstatistical sampling compute a corresponding sample size using statistical theory."

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3) Highlight Expected Changes to Practice in Proposed Standards

We note that Board member Charles D. Niemeier suggested at the Board's December 17, 2009 open meeting that the PCAOB should more clearly express what they want to change in auditor performance as part of the release of a proposed standard. We agree that this would be extremely helpful to facilitate the public comment process. We therefore encourage the Board to include a listing of the interim standards that are being amended or superseded together with a concise summary of what the Board intends to change with respect to auditor performance in the introductory text of a proposed standard. When relevant, references might also be included to other sections of the release text to provide further insights with respect to proposed changes.

4) Marked Comparisons to Prior Proposals and Extant Standards

When standards are reproposed, we believe the Board should provide a marked version of the new proposal to facilitate the identification of the changes from the original proposal. Although this would be helpful for any reproposal, it would be particularly helpful for larger projects with relatively short comment periods such as this one.

In addition, when the Board proposes extensive conforming amendments to its standards, we believe the Board should provide the entire text of the extant standard marked for the proposed changes to allow commenters to better evaluate the impact of the changes. In particular, the proposed conforming amendments to the Board's interim standard AU 316, *Consideration of Fraud in a Financial Statement Audit*, significantly affect that standard. Issuance of the full standard marked for the proposed amendments would allow commenters to more effectively consider the extent and implications of the proposed changes.

Effective Date

We believe the proposed effective date (for audits of fiscal years beginning on or after December 15, 2010) may be aggressive in light of the need to consider public comment and revise and adopt final standards, while allowing sufficient time for the SEC to expose and approve the standards. Given the scope of the proposed standards and the significance of the changes from current standards, and because the proposals are relevant to the planning process, we believe audit firms around the world should be provided additional time to incorporate the standards into their audit methodology and to complete related training programs prior to the beginning of the year in which the proposed standards would apply.

Therefore, to the extent the final standards are not approved by the Board and the SEC by approximately June 30, 2010, we strongly request that the Board consider a later effective date.

* * * * *

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We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have. Please contact Michael J. Gallagher (973-236-4328), Brian R. Richson (973-236-5615) or Brian T. Croteau (973-236-4345) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP

Attachment

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APPENDIX

Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* and *Related Amendments to PCAOB Standards

This appendix provides our detailed comments specific to each of the seven proposed standards and the related amendments to PCAOB standards for the Board's consideration.

Appendix 1: *Audit Risk*

Paragraphs 9 and 10

- We believe the proposed standard would be improved by incorporating additional guidance from the Board's interim standards that articulates more clearly how the auditor applies the audit risk model in performing the audit. In particular, we do not believe the linkage between the auditor's assessment of inherent and control risk and auditor's determination of the acceptable level of detection risk is as clear in the proposed standard as it is in the Board's interim standards. We recommend that the Board consider incorporating into paragraph 9 of the proposed standard the first sentence of paragraph 81 of AU 319, *Consideration of Internal Control in a Financial Statement Audit,* and also align the guidance in paragraph 10 more closely with that in paragraph 28 of AU 312, *Audit Risk and Materiality in Conducting the Audit,* as shown below. These proposed revisions will also create better linkage between this standard and the discussion of the auditor's control risk assessment in the proposed standard *The Auditor's Responses to the Risks of Material Misstatement*.

  Detection Risk

  9. In the audit of the financial statements, detection risk is the risk that the procedures performed by the auditor will not detect a misstatement that exists and that could be material, individually or in combination with other misstatements. ***The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions.*** The level of detection risk is reduced by performing substantive procedures. Detection risk is affected by the effectiveness of the substantive procedures and of their application by the auditor.

  10. ~~For a given level of audit risk, the acceptable level of d~~ ***D***etection risk bears an inverse relationship to ***inherent and control risk*** ~~the risk of material misstatement at the assertion level~~. The ***less*** ~~lower~~ the ***inherent and control risk the auditor believes exists*** ~~of material misstatement~~, the greater the detection risk that can be accepted. Conversely, the greater the ***inherent and control risk the auditor believes exists*** ~~risk of material misstatement~~, the less the detection risk that can be accepted. As the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase.

Appendix 2: *Audit Planning and Supervision*

Paragraph 14

- We believe the requirement to "vary the nature, timing, and extent of audit procedures at locations or business units from year to year" is overly prescriptive because it limits

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APPENDIX

flexibility in determining the acceptable methods of introducing unpredictability in the procedures performed in multilocation audits.

In contrast, paragraph 5(c) of proposed auditing standard *The Auditor's Responses to the Risks of Material Misstatement,* to which reference is made in the paragraph 14, permits such flexibility and identifies the following examples of ways in which unpredictability can be incorporated in the selection of audit procedures to be performed, including, for example, by changing the locations selected for testing from year to year:

> 5(c)…Examples of ways to incorporate an element of unpredictability are (a) performing audit procedures related to accounts, disclosures and assertions that would not otherwise be tested based on their amount or the auditor's assessment of risk; (b) varying the timing or location of the audit procedures; (c) selecting items for testing that have lower amounts or are otherwise outside customary selection parameters; and (d) performing audit procedures on an unannounced basis.

We recommend deleting paragraph 14 and adding "varying the nature, timing and extent of audit procedures at locations or business units from year to year in multilocation audits" as another example in paragraph 5(c) of proposed standard *The Auditor's Responses to the Risks of Material Misstatement*.

Footnote 12

- This footnote, shown below, is based on paragraph 37 of Interpretation 3, "Responsibility of Assistants for the Resolution of Accounting and Auditing Issues," of the Board's interim standard AU 311, *Planning and Supervision*, which will be superseded on adoption of the proposed standard. We believe the footnote suggests that this guidance is included in the Board's interim standard AU 230, *Due Professional Care in the Performance of Work,* when it is not. We believe this is helpful application guidance that should be added to paragraph 23(b) of the proposed standard and the footnote deleted.

> [12] In applying due professional care in accordance with AU sec. 230, each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or auditor's report, however those disagreements or concerns may have arisen.

Appendix 4: *Identifying and Assessing Risks of Material Misstatement*

Paragraph A5

- We believe that the definition of "significant risk" should be revised as shown below to make it clear that these are risks that are designated as such by the auditor.

> A5. Significant risk —A risk of material misstatement that ***the auditor determines*** requires special audit consideration.

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APPENDIX

Paragraph 11

- We recommend modifying the introductory language as shown below to provide appropriate flexibility for the auditor to tailor the application of this requirement, including the nature and extent of procedures performed, to facts and circumstances of each audit. For example, we are concerned that "obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders to identify potentially significant unusual developments (e.g., from Forms 3, 4, 5, 13D and 13G)" might result in auditors expending significant efforts to obtain, review, and document such information without a commensurate increase in audit quality.

  11. The auditor also should consider ***whether and to what extent to*** perform~~ing~~ the following procedures as part of obtaining an understanding of the company:

Paragraph 13

- The terminology "necessary disclosures" in the last sentence of this paragraph should be clarified to make an explicit link to the disclosures required by the applicable financial reporting framework. In addition, we believe the requirement to identify disclosures should be modified to incorporate the clarifying language about the requirement from page A9-30 of the Board's proposal which seems more consistent with the context of obtaining an understanding of the company's selection and application of accounting principles. Accordingly, we recommend changing the last sentence as shown below:

  13. As part of obtaining an understanding of the company's selection and application of accounting principles, including related disclosures, the auditor should evaluate whether the company's selection and application of accounting principles is appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the relevant industry. Also, to identify and assess risks of material misstatement related to omitted or incomplete disclosures, the auditor should ***develop expectations about the types of*** ~~identify the~~ ~~necessary~~ disclosures for the company's financial statements ***that are required by the applicable financial reporting framework***.

Paragraph 20

- We suggest in our comment letter that the Board retain paragraphs 64-65 as optional guidance on walkthroughs and move these paragraphs, as proposed to be amended, to follow paragraph 20. If the Board does not accept this suggestion, we recommend adding a sentence to the second Note in paragraph 20 that states "walkthroughs that include these procedures ordinarily are sufficient to determine that a control has been implemented" to clarify that walkthroughs are sufficient for evaluating not only the design of a control, but also whether a control has been implemented.

Paragraph 42

- We believe the requirement in this paragraph should be aligned with Interpretation 1, "Communications Between the Auditor and Firm Personnel Responsible for Non-Audit Services" (AU 9311.01-.03) of the Board's interim standard AU 311, *Planning and Supervision* to allow for the exercise of judgment in determining which services are likely to be relevant to the auditor's risk assessment rather than creating a mechanical

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APPENDIX

requirement that is not based upon risk or judgment. Accordingly, we recommend the revisions shown below:

> 42. ***The auditor should consider the nature of non-audit services that have been performed for the company and assess whether the services involve matters that might be expected to be*** ~~If the auditor has obtained other information~~ relevant to identifying risks of material misstatement ~~through other engagements performed for the company, the auditor should take that into account in identifying risks of material misstatement~~.

Paragraph 54

- We recommend that the Board include additional language from paragraph 24 of the PCAOB's extant AU 316, the source for paragraph 54, in the second sentence of this paragraph as shown below. Retaining the extant language will make clear that the auditor is to make a determination about the extent of such inquiries and explicitly relates the need for these inquiries to the risks of material misstatement.

> 54. . . . The auditor should identify other individuals within the company to whom inquiries should be directed ***and determine the extent of such inquiries*** by considering whether others in the company might have additional knowledge ***that will be helpful to the auditor in identifying risks of material misstatement due to*** ~~about~~ fraud, alleged or suspected fraud….

Paragraph 56

- Paragraph 56d requires auditors to consider the likelihood and magnitude of potential misstatements to assess the possibility that the risk could result in a material misstatement of the financial statements. However, we note that paragraph 56f, which requires auditors to determine whether any of the identified and assessed risks of material misstatement are significant risks, does not contain similar language related to an auditor's consideration of likelihood and magnitude when evaluating whether an identified risk is a significant risk. While the Note to 56f correctly states that the determination of significant risk is based on inherent risk, without regard to the effect of controls, we believe an auditor's evaluation of whether or not a risk is significant includes consideration of the likelihood and magnitude of the risk of misstatement. These considerations include the ability to control the risk (i.e., as opposed to how a risk is actually controlled). For example, the degree to which a risk tends to be subject to systematic processing and the degree of required management judgment involved influences relevant likelihood considerations in determining significant risks. As such, we recommend the Board clarify that likelihood and magnitude are factors for consideration in significant risk determinations.

Appendix 5: *The Auditor's Responses to the Risks of Material Misstatement*

Paragraph 2

- We are pleased about the addition of "assessed" preceding "risks" throughout the standard because it incorporates the linkage between the auditor's risk assessment and the auditor's response that was missing in the prior proposal. For similar reasons, we believe the objective of the auditor in this standard should also include "assessed" risk terminology.

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APPENDIX

2. The objective of the auditor is to address the ***assessed*** risks of material misstatement through appropriate overall audit responses and audit procedures.

Paragraph 6

- We believe that using the term "pervasive" to characterize changes to the nature, timing and extent of audit procedures described in this paragraph is both unclear and unnecessary. We recommend deleting the term.

Paragraph 16

- We recommend deleting footnote 8 to this paragraph which states "Reliance on controls, when appropriate, allows the auditor to assess control risk at less than the maximum, which results in a lower assessed risk of material misstatements. In turn, this might allow the auditor to modify the nature, timing, and extent of planned substantive procedures." We believe the footnote is unnecessary and the "might allow" language also appears to be inconsistent with the auditor's ability to modify the nature, timing and extent of substantive procedures based on an appropriately supported control risk assessment that is below the maximum.

Appendix 6: *Evaluating Audit Results*

Paragraph A2

- We suggest changing the order of the first and second sentences in the definition of misstatement so that the discussion of material misstatement follows the identification of sources of misstatement.

Paragraph 15

- We recommend that the PCAOB incorporate paragraph 9 of ISA 450, which requires the auditor to obtain an understanding of management's reasons for not correcting misstatements and to take that understanding into account when evaluating whether the financial statements as a whole are free of material misstatement, after paragraph 15 of the proposed standard.

Appendix 7: *Audit Evidence*

Overall

- The term "persuasive" is used in the proposed standard *The Auditor's Responses to the Risks of Material Misstatement* and in other areas of the Board's interim standards to describe the nature of evidence obtained through the audit. However, "persuasive" is not described in the proposed *Audit Evidence* standard despite the fact that it is intended to describe a characteristic of audit evidence. We believe that its lack of use in this standard, which provides guidance related to the evaluation of audit evidence, may lead to confusion as to how the persuasiveness of audit evidence affects an auditor's consideration of the sufficiency and appropriateness of audit evidence. Therefore, we recommend the Board

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consider clarifying the manner in which the persuasiveness of evidence impacts the evaluation of audit evidence within this standard.

Paragraph 18

- The second sentence of this paragraph in the prior proposal, which stated "Written confirmations might be received in paper form, or by electronic or other medium," has been omitted. We believe this sentence should be restored because paragraph 29 of the PCAOB's interim standard AU 330, *The Confirmation Process*, presumes that confirmations will be written by stating: "There may be situations in which the respondent, because of timeliness or other considerations, responds to a confirmation request other than in a written communication mailed to the auditor. When such responses are received, additional evidence may be required to support their validity."

  We understand that the PCAOB is considering a proposed revision of AU 330; however, we believe the concept that confirmations are written responses should be restored to paragraph 18 so that the proposed standard is consistent with extant AU 330.

Appendix 8: Proposed Conforming Amendments to PCAOB Standards

- We suggest replacing "evidential matter" with "audit evidence" in the proposed conforming amendments addressed in item "d" of AU sec. 329, "*Analytical Procedures*" and in item "b" of AU sec. 350, "*Audit Sampling*." In addition, we suggest adding a third bullet to the proposed conforming amendment addressed in item "i" of AU sec 329 to replace "evidential matter" with "audit evidence" in the third sentence of paragraph .21.

Texas Society of
Certified Public Accountants

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 026
"Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards"

To Whom It May Concern:

One of the expressed goals of the Texas Society of Certified Public Accountants (TSCPA) is to speak on behalf of its members when such action is in the best interest of its members and serves the cause of Certified Public Accountants in Texas, as well as the public interest. The TSCPA has established a Professional Standards Committee (PSC) to represent those interests on accounting and auditing matters. The PSC has been authorized by the TSCPA's Board of Directors to submit comments on matters of interest to the PSC's membership. The views expressed in this letter have not been approved by the TSCPA's Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policy of the TSCPA.

In our discussion of the above referenced exposure draft (ED), we considered each of the 18 questions posed by the PCAOB in Appendix 9. We are basically in agreement with the guidance found in the proposed ED and have no comments related to 15 of the 18 questions found in Appendix 9. We do have comments related to three of the questions that we would like the Board to consider as it moves forward with this ED. The three questions we have commented upon are questions 10, 15, and 16. Those comments are noted below with reference to the question being addressed.

Question 10: Are the auditor's responsibilities regarding the additional procedures for understanding the company and its environment in paragraph 11 clear?

Paragraph 11 requires the auditor to basically evaluate the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting in the following areas: (1) company-issued press releases, company-prepared presentation materials for analysts or investor groups, and analyst reports; (2) transcripts of earnings calls and, to the extent publicly available, other meetings with investors or rating agencies; (3) compensation arrangements with senior management; and (4) information about trading activities in the company's securities and holdings in the company's securities by significant holders to identify potentially significant unusual developments.

We find the guidance regarding these responsibilities to be inadequate. In the area of company-issued press releases and presentation materials for analysts, to what extent is the auditor required to delve into these documents? If the materials presented to the analysts and investors are inconsistent with the financial statement results, does this constitute a material financial statement misstatement? Don't

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the analysts and investors have a responsibility to gauge the consistency of the presentation material with the entity's financial results?

Point two above requires the auditor to observe or read transcripts of earnings calls and, to the extent publicly available, other meetings with investors or rating agencies. What happens in situations where this information is not publicly available but the auditor has access to it through the performance of audit field work? Is the auditor required to scrutinize this data to the same extent as data that is publicly available? Does the public availability of such data serve as a key element in its relevance?

Regarding information about trading activities in the company's securities, as well as holdings in the company's securities by significant holders, we have some concern about the meaning of the phrase "potentially significant unusual developments." The Board obviously had some reason for this concern and the potentially significant unusual developments that might arise. We believe some guidance in the kind of "unusual developments" anticipated in this area would be helpful to practitioners. We realize that auditors can utilize specialists to examine and assess any problems that are identified in dealing with company securities. However, the first step is to know when a potential problem might exist. The sophisticated nature of equity schemes cause them to be difficult to identify in the normal course of an audit engagement.

What we would like the Board to consider in this area is some additional guidance as to the key factors that may alert an auditor to (1) delve into press releases and data presented to analysts, (2) read transcripts of earnings calls and meetings with investors or rating agencies, and (3) obtain information about trading activity in the company's securities and holdings in the company's securities by significant holders. We are not advocating a step-by-step approach to such considerations, merely some examples of factors that indicate "potentially significant unusual developments" related to the issues addressed in Paragraph 11.

Question 15: Does the new proposed standard clearly describe the auditor's responsibilities for accumulating and evaluating misstatements?

The proposed standard clearly describes the auditor's responsibilities for accumulating and evaluating misstatements. However, we suggest presenting these responsibilities as an addendum to the SEC report in an effort to promote greater transparency. The issues being addressed here involve estimates and disclosure of the basis for the estimates. The methodology underlying the development of the estimates would enhance a reader's understanding.

Additionally, we suggest sending the adjustments *not made* in a separate file that the PCAOB could access at a later date, should there be a subsequent desire to review this information.

Question 16: Does the new proposed standard appropriately describe the auditor's responsibilities for evaluating the presentation of the financial statements, including evaluating bias, in light of the auditor's responsibility to opine with reasonable assurance on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?

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1666 K Street, N.W.
Washington, DC 20006-2803
Page Three

Basically, our answer to this question is yes. However, the concept of bias is present not only in the development of estimates but also in the design of control systems and the selection of accounting policies and procedures. Thus, all elements of an entity's financial statements are exposed to bias and should be subjected to auditing procedures.

Also, item 27 in Appendix 6 uses the term "income" rather than "income or loss". We suggest the use of "income or loss" would be more appropriate.

We appreciate the opportunity to provide input into the standards-setting process.

Sincerely,

Melissa A Frazier

Melissa A. Frazier, CPA
Chair, Professional Standards Committee
Texas Society of Certified Public Accountants

ICAEW

2 March 2010

Our ref: ICAEW Rep 26/10

Office of the Secretary
PCAOB
1666 K Street
N.W.
Washington
D. C. 20006-2803.

By email: comments@pcaobus.org

PCAOB Rulemaking Docket No. 026

Dear Sir

PCAOB RELEASE NO 2009 - 007: PROPOSED AUDITING STANDARDS RELATED TO THE AUDITOR'S ASSESSMENT OF AND RESPONSE TO RISK AND RELATED AMENDMENTS TO PCAOB STANDARDS

The ICAEW welcomes the opportunity to comment on the PCAOB's re-proposed auditing standards on risk assessment and consequential conforming amendments published in December 2009.

The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the ICAEW provides leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The ICAEW is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

Our comments have been prepared with the help of many of our members working around the world who have detailed knowledge and practical experience of US, EU and other regulatory regimes. We have not sought to answer the PCAOB's specific questions but instead provide main and detailed comments resulting from our discussions. We hope that this approach is of value to the PCAOB.

We congratulate the PCAOB on an improved set of proposed standards, its decision to re-expose them, and an improved, albeit incomplete, statement of the differences between PCAOB standards and ISAs. The PCAOB has a duty to protect US investors and an absolute right to set whatever standards it considers appropriate in order to achieve this. But it also has a responsibility to engage with standard-setters internationally in the interests of audit quality and for reasons of self-interest. This means convergence in both directions: convergence of international standards with PCAOB standards as well as the other way round.

The Institute of Chartered Accountants in England and Wales
Chartered Accountants' Hall
Moorgate Place London EC2R 6EA UK
icaew.com

T +44 (0)20 7920 8100
F +44 (0)20 7920 0547
DX 877 London/City

The PCAOB can and should influence international standard-setting more effectively than it does at present. The ICAEW has a strong interest in the continued improvement of ISAs and the PCAOB is in an ideal position to act as a catalyst for this. Some differences between PCAOB standards and ISAs are inevitable in order to address specific US requirements. While Appendix 10 is helpful to a degree, it often simply notes the differences, or states that they are important, or notes similarities without explaining why the same terminology cannot be used. It does not state whether the differences are necessary to address specific US requirements, nor does it detail those elements of ISAs that are not reflected in PCAOB standards or the rationale for their exclusion (such as the possibility of the combined assessment of inherent and control risk).

These standards are of fundamental importance because so many other standards are built on the same foundations. Going the extra mile on quality and convergence on this occasion will pay dividends because the opportunity to revise these standards is unlikely to arise again soon; we therefore encourage the PCAOB to do so. A majority of responses to the original proposals were strongly in favour of further elimination of differences between PCAOB standards and ISAs. We struggle to see the benefit of many of the differences the PCAOB is proposing to retain and we have doubts as to the extent to which such differences will drive significant changes in behaviour or improvements in audit quality. Wherever possible we believe minor differences in detail between the PCAOB's standards and ISAs should be eliminated. Including minor differences is likely to result in either extensive form filling exercises that contribute little to an effective audit, or substantial overlap of closely related areas for compliance purposes leading to a loss of focus on more important areas. Attempts may also be made to exploit such differences in vexatious litigation.

Audit quality is as much, probably more, about the quality of monitoring, oversight and the right sort of enforcement, as it is about fine details in standards. However, convergence of auditing standards offers significant benefits in terms of consistency and high quality in audits of entities with operations in multiple countries. Large and mid-tier firms around the world, particularly members of the Forum of Firms, use ISAs as the basis for their core methodologies which promotes audit quality because it facilitates training and education of staff and enhances the consistency and effectiveness of multi-national audits. Where substantive differences remain, a comprehensive description of the differences between PCAOB standards and ISAs is essential to ensure that any incremental procedures required by PCAOB standards are effectively executed.

These standards aside, we are pleased to note the PCAOB's growing mindfulness of the importance of convergence. A strategic goal supported by a detailed roadmap is the right way to achieve convergence and we encourage the PCAOB to consider the possibility of this carefully in the light of:

- its own ambitious standard-setting plans;
- the convergence with ISAs of many other standard-setters, including the AICPA and others in North America; and
- the emerging problems associated with developing standards without some sort of framework or objective, such as inconsistent styles of standard which are difficult to apply consistently or update.

Going forward, it will be enormously helpful to the international standard-setting process if the PCAOB can be crystal clear about which areas of PCAOB standards it believes to be technically better than ISAs, and why. The PCAOB should challenge the IAASB in areas in which it believes ISAs can and should be improved. These standards are the place to start.

In order to be clear about differences and changes, the following analyses are needed:

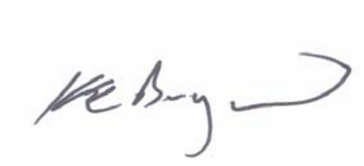
- a mark-up of the original proposal which would better illustrate the revisions made;
- cross-references of the explanations of the changes made between Appendix 9 to the revised proposals;
- a description of the significant changes in practice that the PCAOB anticipates as a result of the revised standards; and
- a description of the significant differences that the PCAOB believes exist between the proposed standards and ISAs (and ASB standards).

We also encourage the PCAOB to consider the need for a final exposure. This is by no means unprecedented. The IAASB recently exposed its standard on group audits three times, considering it to be of critical importance, and it developed its risk standards over a period of almost three years. We do not suggest extending the process for the sake of it, but we believe that getting it right first time in this area will result in a better quality corpus of PCAOB standards, and more influence internationally, in years to come.

Main and detailed comments are set out below.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely



Katharine E Bagshaw FCA
Manager, Auditing Standards
ICAEW Audit and Assurance Faculty
T + 44 (0)20 7920 8708
F + 44 (0)20 7920 8754
E: kbagshaw@icaew.com

MAIN COMMENTS

Proposed implementation date

Notwithstanding our comments above about the need for careful consideration of further re-exposure, the proposed implementation date for audits of fiscal years beginning on or after 15 December 2010 seems workable provided that the standards are approved by the SEC by mid-2010. Should this timetable slip, the effective date would need to be revised.

Drafting

Foundational principles

We note that neither foundational principles nor any system for developing objectives is apparent in the re-exposed standards. We have made the same comments in the past to the IAASB and we hope that going forward, both the PCAOB and the IAASB will consider these issues critically in the light of experience.

The structure of the standards

The style of the re-proposed standards is different to extant standards. Structure matters and there are many more notes in these standards than in others, and within these there are requirements. Similar considerations apply to appendices. We fear that notwithstanding PCAOB statements as to status, questions will arise as to the relative importance of requirements in standards, the notes, and appendices that may well lead to extended debates with counsel and others. If there is no difference in the status of requirements, why have notes and appendices? We recommend that the PCAOB consider the relatively simple solution to this problem adopted by the IAASB, which has mandatory requirements in one part of the standard (not in notes), and no requirements in application material or appendices. We note that a number of mandatory requirements in the PCAOB standards appear as application material in the ISAs which may add further weight to inappropriate attempts to distinguish between categories of requirements.

Terminology and definitions

The PCAOB has chosen to retain some formulations that are not aligned with ISAs, particularly in the context of materiality. The use of the old term ‘tolerable misstatement’ stands out. The fact that the concept is understood by auditors is not of itself a reason for not changing it and the PCAOB should at least consider the rationale for the change in ISAs. The fact that the term is used in the context of sampling does not mean that it is appropriate to use it in the context of the overall risk assessment.

It would be helpful for the PCAOB to highlight terminology and definitions that are not aligned with ISAs which (in its view) represent *no* significant difference to the terminology and definitions used by the IAASB. We also hope that the PCAOB will seek to advance the case for differences (such as the preference for ‘appropriately low level’ over ‘acceptably low level’ in the context of risk reduction) to the IAASB when the subject is next considered.

Substantive issues

Significant risks, fraud, and judgement

We are encouraged by the additional focus on fraud but remain concerned that auditors may inadvertently be encouraged to do too much. Paragraph 53 of the proposed standard *Identifying and Assessing Risks of Material Misstatement* Appendix 3 paragraph 52(d), describes the procedures the auditor should perform for specific inquires about fraud, whereas ISA 240 permits the use of judgement. In that context, we note the point made on page A9-4 of the Additional Discussion about the PCAOB’s hesitation in making references to judgement in selected portions of standards, because it may imply that the auditor should not use judgement elsewhere. Even if this misinterpretation were likely (and we would hope that that most auditors are not so rigid and unthinking as to assume that judgement is prohibited unless permitted) we believe it better to state in the standards that judgement is required in fulfilling all requirements, and that there is a particular need for the exercise of judgement in certain areas, as noted in the standards.

Case law in auditing standards

We do not contest the rationale for the inclusion of references to a 'reasonable investor' in the re-proposed standard on materiality. However, we do not think it necessary to make this reference, and draw the PCAOB's attention to the fact that the issue of materiality has been considered by the courts in many jurisdictions and that auditing and accounting standard-setters in those jurisdictions have not found it necessary to make references to specific to court cases in standards, relying instead on their own knowledge and experience, and those of others, nationally and internationally, to formulate a definition of materiality for audit purposes. Furthermore, we believe it inadvisable to use case law in auditing standards and urge the PCAOB to consider carefully whether this is a helpful precedent to set. Case law changes, one case affect the nuances of another and in a relatively short space of time, the reference can be outdated. Auditing standards are not legal documents and while references to statutes and regulation are acceptable, we believe that references to case law are less helpful. We suggest as a minimum that the reference to the specific case be taken out of the main body of the standard and included either in a footnote or an appendix.

DETAILED COMMENTS

Audit Risk in an Audit of Financial Statements

1. We remain concerned about the unqualified assertion in paragraph 9 that detection risk is reduced by substantive procedures. We do not contest this assertion, but it is incomplete. We see no acknowledgement here or in the surrounding material, which we agree has been improved, that 'procedures performed by the auditor', which reduce detection risk, include tests of controls, to the extent that the results of such tests will affect the nature and extent of substantive procedures. The implication is that tests of controls are irrelevant to detection risk (reducing the risk of the audit failing to detect that a material misstatement exists) and we do not believe that this is what the PCAOB intends. A statement to the effect that substantive testing is likely to be more important in the presence of heightened detection risk might be more appropriate.

2. The new material in paragraphs 13 and 68 on disclosures might be put into context with a reference to the disclosure requirements of the relevant financial reporting framework.

Audit Planning and Supervision

3. We are pleased to note that the material now in paragraphs 16 *et seq* deals with the issue of specialists generally and not just IT specialists.

4. We note again that the original paragraph 21 requirement regarding processes for disagreements and documentation thereof has been moved in part to AS 3, but we are concerned that the requirement for the engagement partner and team to be aware of how disagreements should be dealt with has gone, and we do not agree that evidence of compliance with this would be difficult to provide. Disagreements are a sensitive area and it is important that staff are aware of how they should be dealt with. It is possible however, that this requirement belongs in a standard on quality control rather than audit planning and supervision.

Identifying and Assessing Risk of Material Misstatement

5. We remain concerned that paragraph 71 continues to assert that all fraud risks are significant risks. We believe that this will lead to over-auditing in immaterial areas. There are many very low level fraud risks which are relatively insignificant. ISA 240 requires fraud risks to be treated as significant risks but the significant risks under ISAs are those risks **that the auditor considers** require special audit consideration. We suggest that the PCAOB definition of significant risks be amended to take in this element of judgement.

6. The new material in paragraph 7 on smaller entities is helpful but it is important to recognise that smaller entities can be complex, and larger ones sometimes simple. The former is more of an issue, because complexity rather than size is likely to heighten risk.

The Auditor's Responses to the Risks of Material Misstatement

7. The new material on walkthroughs needs to clearly distinguish walkthroughs for the purposes of testing design effectiveness, and walkthroughs for the purposes of testing operating effectiveness. Paragraph 20 deals with walkthroughs used for assessing design effectiveness which does not really belong in this standard as it is a risk assessment procedure rather than a response.

Evaluating Audit Results

8. We remain of the view that it is not clear what the additional procedures might be, or what 'determine' means in the note to paragraph 14 (b). It is more likely that the auditor will tell the client to book the adjustment; more work is not always the answer.

Consideration of Materiality in Planning and Performing an Audit

9. The change in paragraph 6 from materiality levels being appropriate in the light of ‘surrounding’ circumstances to ‘particular’ circumstances is hardly an improvement. Neither word is necessary.

Audit Evidence

10. The difference between the wording of the objective in paragraph 3 (the objective of the auditor is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report) and the wording in paragraph 4 (the auditor must design and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion) remains unhelpful.

11. The requirement to modify or perform additional procedures in cases of suspect authenticity in paragraph 9 still needs a link to professional scepticism, and further circumscription. Many modifications are routine and to treat them as suspect may create inappropriate expectations.

The Institute of Internal Auditors

Richard F. Chambers
Certified Internal Auditor
Certified Government Auditing Professional
Certification in Control Self-Assessment
President and Chief Executive

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February 18, 2010

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803 USA

Response e-mailed to comments@pcaobus.org

RE: PCAOB Rulemaking Docket Matter No. 026: Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk

Dear Sir/Madam:

The Institute of Internal Auditors (IIA) welcomes the opportunity to respond to the revisions to the PCAOB's proposed auditing standards related to the auditor's assessment of and response to risk. Our comments are based on a thorough analysis and discussion, utilizing a core team of audit experts who serve on The IIA's Professional Issues Committee. These individuals consist of Certified Public Accountants and Certified Internal Auditors who have worked in public accounting and in management position in small, medium, and large multinational companies.

These standards are extremely important to The Institute as our members work closely with external auditors on a daily basis. They will have a tremendous influence on the manner in which audits are performed and the level of testing required during an audit. As internal audit professionals, we are well-positioned to understand the true impact the standards have on audit practices as well as on governance and control practices within companies.

We applaud the PCAOB's revisions to the original proposed standards. We believe these standards to be of high quality, and the changes in the draft, as advocated by many respondents, have aided in the improvement of such standards. We believe the transparency shown by the PCAOB in providing a second comment period enhances the objectivity of the process and exemplifies the professionalism of the PCAOB standards-setting process.

The following are our principal comments and observations. Detailed responses to the questions posed in the exposure document, and other matters related to specific standards, can be found in Attachment A.

1. We recommend simplifying the overall language within each of the standards, with more examples to reduce the chance of practitioner misunderstanding. In addition, avoiding unnecessary terms will ensure that the reader clearly understands the definition and intent of essential terms within the standards.

Global Headquarters
247 Maitland Avenue
Altamonte Springs, FL
32701-4201 USA
T: +1-407-937-1100
F: +1-407-937-1101
www.theiia.org

2. All seven proposed standards are rooted in the concept of audit risk. As such, we recommend improved references in the "Audit Risk" proposed standard to the other six proposed standards. In addition, all seven standards would benefit by including enhanced references and links to other related guidance. While we recognize the desire to limit cross references and have each standard "stand" alone, the reality is that these standards rely on one another to be understood and properly executed.

3. As the standards are written, there is not a clear connection between the various components of audit risk and how such risks impact the risk assessment process. All risk types should be clearly defined in the standards to explain how these risk types correlate. Specifically, a clearer discussion of the interrelationship of inherent risk, control risk, detection risk, and audit risk should be considered. Practitioners should clearly understand how inherent risk influences the <u>expected</u> design and operating effectiveness of internal controls that practitioners encounter during compliance testing to assess control risk. The level of substantive procedures is influenced by the final level of control risk (determined after the assessment of inherent risk and results of the compliance assessment) and level of detection risk the auditor is willing to accept. Inherent, control, and detection risk are not evaluated in separate silos. The increase or decrease in one — as evaluated by the practitioner throughout the course of the audit — will influence the others. This interaction should also be discussed, with relevant examples.

4. We recommend a standard on audit supervision be separated from the standard on planning as they are two individual and distinct topics. A discussion on supervision could better delineate the roles and responsibilities of the engagement partner versus other members of the audit team, as well as discuss the concept of risk and level of review that are currently discussed in the proposed standard, "The Auditor's Responses to the Risks of Material Misstatement." By including all aspects of supervision within one standard as opposed to including aspects throughout the other standards, we believe it strengthens the message of the standards as a whole.

The IIA welcomes the opportunity to discuss any and all of these recommendations with you. We offer our assistance to the PCAOB in the continued development of this guidance.

Best Regards,

Richard F. Chambers, CIA, CGAP, CCSA
President and Chief Executive Officer

About The Institute of Internal Auditors
The IIA is the global voice, acknowledged leader, principal educator, and recognized authority of the internal audit profession and maintains the *International Standards for the Professional Practice of Internal Auditing* (*Standards*). These principles-based standards are recognized globally and are available in 29 languages. The IIA represents more than 170,000 members across the globe and has 103 affiliates in 165 countries that serve members at the local level.

Attachment A
Institute of Internal Auditors (IIA)
Response to PCAOB – Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk

Questions from Appendix 9 of the proposed standards are in bold italics, with The IIA's responses following.

General Areas of Comment on the Original Proposed Standards

1. ***Are the objectives in the proposed standards useful in providing context for the requirements in the standards?***

   Yes.

Other Comments:

Other general comments have been highlighted in the response letter itself.

Proposed Standard - Audit Risk in an Audit of Financial Statements

2. ***Does the new proposed standard on audit risk describe clearly the concept of audit risk and its components?***

   No. We believe improved clarity relating to audit risk and the various components of audit risk, including relevant examples, would strengthen the proposed standard. In addition, risk should be assessed at the assertion level only as a mechanism to determine the level of risk at the financial statement line item or disclosure level, not as a stand-alone assessment. This distinction should be clarified.

3. ***Does the new proposed standard on audit risk describe clearly the relationship between detection risk and substantive procedures?***

   No. As it is written, the proposed standard does not provide clarity. We recommend the language be modified to clarify the fact that detection risk can be reduced by varying the nature, timing, and extent of procedures to be performed. In addition, we believe that the concept of control risk should also be a key part of this discussion, as practitioners should understand how all the components of risk should be considered in tandem when performing an audit.

Other Comments:

We recommend that paragraph 6 be enhanced by altering the examples provided. "A lack of sufficient capital" is not directly tied to a risk of material misstatement. Alternative language might be stylized as "A lack of sufficient capital or … may increase the level of fraud risk, drive a decline in control systems, or influence an increase in risk taking by the firm — all of which may lead to a higher risk of material misstatement." In addition, more information on inherent risk and related examples would clarify this proposed standard.

We believe the standard could be improved by adding a discussion of the connection between the adequacy of a company's system of internal controls and the likelihood of a material misstatement. Currently, paragraph 9 of this proposed standard states: "The level of detection risk is reduced by performing substantive procedures." The word "performing" should be replaced with "adjusting the nature, timing, and extent of." In addition, this paragraph does not adequately link the concepts of inherent risk and control risk from paragraph 7 to detection risk in paragraph 9. As it is currently written, the basic approach of the standard is that there is a binary view of control risk — it either is at maximum or at some low level. In reality, however, control risk varies between these extremes. Understanding the components of internal control, and the level of control risk, is critical when assessing the level of substantive testing required to overcome the inherent risk of material misstatement. As currently stated, the standard implies that the effectiveness of the design and operation of internal controls is irrelevant to the level of substantive testing needed. The standard should clearly explain that inherent risk can be reduced by the adequacy of the company's system of internal controls, while the adequacy of the controls and resulting control risk determination can have an impact on the level of substantive testing required.

Proposed Standard – Audit Planning and Supervision

4. ***Are the proposed requirements for multi-location engagements appropriately aligned with Auditing Standard No. 5?***

   Yes.

5. ***Is it clear how the proposed requirements for multi-location engagements would be applied in audits of financial statements only?***

   Yes.

6. ***Are the differences between the responsibilities for supervision of engagement team members and oversight of specialists in accordance with AU sec. 336 appropriate in light of the auditor's responsibilities to opine with reasonable assurance on whether the financial statements are fairly presented, in all material respects, in conformity with the applicable financial reporting framework?***

   Yes, but we recommend adding language to stress the importance of assessing the independence of specialists used during an audit.

   Other Comments:

   We believe the language included in paragraphs 20 and 21 regarding initial audits is too brief for the importance of this discussion. We suggest inserting language to emphasize the additional risks associated with a new client as well as the additional procedures that should be performed in these circumstances. Discussion of the increased level of detection risk inherent in initial engagements should be emphasized.

   As noted in our overall comments, we believe supervision deserves a separate standard with expanded details regarding expectations for supervision such as the level of partner review of work versus subordinate staff, and the level of supervision of an expert's work product.

Proposed Standard – Consideration of Materiality in Planning and Performing an Audit

7. ***Are the provisions in the new proposed standard regarding consideration of materiality in multi-location engagements appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?***

   Yes.

8. ***Are the revised provisions regarding reassessment of materiality appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?***

   Yes.

Other Comments:

While we believe the new definition of materiality included in paragraph 2 of the proposed standard is excellent, we are not as favorable of the discussion of tolerable misstatement in paragraphs 8 and 9. While we understand this is a tool utilized by some external auditors and may be helpful when auditing large companies, we do not believe it should be a requirement, since this concept may not be as useful when auditing smaller companies. We suggest modifying the language in paragraph 8 around this concept to be a suggestion — "may determine the amount … at the account or disclosure level" — as opposed to a mandate. Paragraph eight should provide guidance to meeting paragraph 3's requirement to "design and perform audit procedures to detect misstatements that, individually or in combination with other misstatements…" The current language could be misinterpreted and result in the auditor applying what is effectively a lower level of materiality and performing unnecessary procedures.

Proposed Standard – Identifying and Assessing Risks of Material Misstatement

9. ***Does the new proposed standard adequately describe the auditor's responsibilities for performing risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of risks of material misstatement due to error or fraud and to design further audit procedures?***

   Yes.

10. ***Are the auditor's responsibilities regarding the additional procedures for understanding the company and its environment in paragraph 11 clear?***

    Yes, although we suggest adding a bullet regarding relationships with insiders (e.g., officers, directors, and stakeholders).

11. ***Are the proposed requirements regarding obtaining an understanding of internal control over financial reporting appropriate in light of the auditor's responsibilities for identifying and assessing the risks of material misstatement?***

    Yes.

12. ***Are the proposed requirements regarding the discussion among engagement team members about risks of material misstatement appropriate given the auditor's responsibilities for identifying and assessing the risks of material misstatement?***

    Yes.

Other Comments:

Related to this proposed standard, we recommend several sections be rewritten or expanded upon to improve the messages included therein. First, we recommend expanding upon examples included in paragraphs 16 and 17 on company performance measures to clarify this discussion and why this understanding is useful when identifying and assessing risks of material misstatement. As it is written, the vagueness of the term "company performance measures" could cause confusion as to the true intent of this proposed standard, and the examples provided do not explain why the measures are useful to the assessment process. For instance, these measures may become the basis for pressure on company executives. As it is written, the language appears to reference entity-level controls performed by management, which would reduce risk if deemed adequate. We believe the intent is to require the auditor to consider business trends and activities that may increase pressure on management and therefore increase the risk of inappropriate accounting due to a lapse in internal controls or fraud. These performance measures influence inherent risk which in turn influences control and detection risk.

Second, related to paragraph 69, we believe that while the presumption should be that improper revenue recognition (fraud) is a higher level risk, this presumption is not correct for every industry and company. As a result, we recommend rewording this paragraph to state that while revenue recognition should be presumed to represent a higher level risk, there are exceptions. In those cases, a determination that this risk is less than high risk for revenue recognition should be documented appropriately.

Finally, we believe the concept of significant risks included in paragraph 71 should be defined prior to this discussion to provide more insight to the reader. If the intent is to label these examples as having a higher likelihood of leading to a material misstatement, then the factors for evaluating the risk should be listed. If the intent is to label these examples as events that require additional emphasis and special audit procedures regardless of risk level in a given organization, then there should be an explanation as to why there is an emphasis on these items and what special procedures should be performed. It is not clear that special procedures are required if risk levels are not high.

Proposed Standard – The Auditor's Responses to the Risks of Material Misstatement

13. ***Are the proposed requirements for overall responses and responses involving the nature, timing, and extent of audit procedures appropriate given the auditor's responsibility to opine with reasonable assurance about whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?***

    Yes.

14. ***Does the new proposed standard clearly describe when tests of controls are necessary in an audit of financial statements only?***

    Yes. However, it is not clear which standards apply to financial statements only. We assume, with the exception of paragraphs 16 through 18, all sections of the standards apply to both integrated audits and audits of financial statements only.

Proposed Standard – Evaluating Audit Results

15. ***Does the new proposed standard clearly describe the auditor's responsibilities for accumulating and evaluating misstatements?***

    Yes.

16. ***Does the new proposed standard appropriately describe the auditor's responsibilities for evaluating the presentation of the financial statements, including evaluating bias, in light of the auditor's responsibility to opine with reasonable assurance on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?***

    Yes.

Other Comments:

Paragraphs 10 and 11 introduce the concept of "clearly trivial." The PCAOB may wish to consider introducing this concept in guidance on materiality in the proposed standard "Consideration of Materiality in Planning and Performing an Audit."

Proposed Standard – Audit Evidence

17. ***Does the new proposed standard describe clearly how the auditor should determine the financial statement assertions to use for both integrated audits and audits of financial statements only?***

No, however, we do not believe the proposed standard should address "how" the auditor should determine the financial statement assertions to use. In addition, we do not believe the assertion discussion in paragraphs 11 and 12 makes sense in the context of this standard. We recommend modifying this section to better align with the topic "Audit Evidence."

18. ***Are there provisions in the to-be-superseded standards that should be retained?***

No.

Other Comments:

Paragraph 11 regarding Financial Statement Assertions is not appropriate in the Evidence Standard. This section is better suited in the standards regarding risk assessment and responses to risk assessment. Not all assertions should be considered at risk of material misstatement for a given organization.

CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

TOM QUAADMAN
EXECUTIVE DIRECTOR, FINANCIAL REPORTING
AND INVESTOR OPPORTUNITY

1615 H STREET, NW
WASHINGTON, DC 20062-2000
(202) 463-5540
tquaadman@uschamber

March 2, 2010

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 026

Dear Members and Staff of the Public Company Accounting Oversight Board:

The United States Chamber of Commerce ("Chamber") is the world's largest business federation representing more than 3 million businesses and organizations of every size, sector, and region. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy.

The CCMC recognizes the vital role of external audits in the sound operation of our capital markets and supports efforts to maintain and improve audit effectiveness. Auditors' assessment of and responses to risk are fundamental to the audit process, and so we appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk*. Our comments focus on the following issues:

1. standard-setting approach and due process
2. convergence of auditing standards
3. disclosure
4. implementation of auditing standards

The PCAOB is re-proposing for public comment seven auditing standards related to risk. The PCAOB's initial draft was proposed on October 21, 2008 and the

CCMC provided comments thereto.[1] While the current iteration of the proposal is an improvement many of the issues previously raised in the CCMC's comment letter of February 18, 2009 remain unresolved.[2] These issues include those related to convergence, fraud, materiality, auditor judgment, and revision of the Interim Standards.

Accordingly, the CCMC requests that these proposals be withdrawn and reevaluated in order to be improved for the purposes of sound financial reporting policy. Properly crafted and implemented standards for risk assessment and response will provide certainty for both investors and businesses. The implementation of deficient standards will foster uncertainty and the unintended economic consequences may result in material losses for investors and businesses.

The CCMC's concerns are listed with greater specificity below.

1. Standard-Setting Approach and Due Process

In our letter of February 28, 2009, we noted that at the October 2008 Standing Advisory Group ("SAG") meeting, the PCAOB staff stated an intention to develop a concept release for public comment and feedback in early 2009 regarding the PCAOB's plans for addressing its review of the Interim Standards. The concept release was to include a schedule and procedures for the review. No such concept release has been forthcoming. The CCMC continues to strongly recommend that this concept release be developed, exposed for public comment, and finalized *before* the Board and staff revise the current Interim Standards. The concept release should include these proposed standards, especially considering the pervasive implications of risk assessment and response for the audit process. Without an overarching plan and framework for revising the Interim Standards or transparency on either,[3] piecemeal and ad hoc changes in existing standards will likely produce inconsistencies in the audit process and undermine audit quality. Such changes can result in confusion and the lack of comprehension regarding the interrelationship of standards and their application due to the different drafting styles and conventions.

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[1] See comment letter from the United States Chamber of Commerce's Center for Capital Markets Competitiveness, dated February 18, 2009, on PCAOB rulemaking docket matter No. 026, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* ("February 18, 2009 comment letter").

[2] The CCMC requests that this letter be read in conjunction with the February 18, 2009 comment letter.

[3] The CCMC has expressed concern about the lack of transparency in the Board's standard-setting process. For example, see CCMC letter to Acting Chairman Daniel L. Goelzer dated October 7, 2009.

Additionally, as pointed out in the February 18, 2009 comment letter, the PCAOB's current proposal produces incongruities when viewed under the parameters of the existing standards. For instance, AU Section 316 is just one illustration. The risk standards currently being proposed by the Board move the requirements related to the auditor's responsibilities in the area of fraud out of the fraud standard and blend them in with other audit requirements. The CCMC disagrees with this approach because AU Section 316 will no longer represent a fraud standard or even a sufficiently comprehensive audit standard in relation to its title. Given the importance of auditor's responsibilities related to fraud to investors and other users of financial statements, it is a mistake to leave AU Section 316 so sparse. This mistake is compounded with the lack of transparency around the PCAOB's future standard-setting plans in this regard.

The CCMC is also concerned about the short period for comment on the current proposal which is 250 pages long and covers seven standards that involve complex inter-relationships as a group and must be considered in the context of other audit standards. Such a short comment period suggests more fundamental problems with the PCAOB's due process for setting auditing standards.[4] Because the comment period encompasses one of the busiest times in the financial reporting arena, realities dictate a lack of analysis and submission of thoughtful comments to the PCAOB. This frustrates the ability of all stakeholders to collaboratively formulate the best standards possible.

Furthermore, the PCAOB has failed to take appropriate steps to facilitate a process that will lead to the submission of robust and diverse comments. It has already been noted that this is the second proposal regarding these standards. It would benefit commenter's to be able to compare the two proposals and existing standards in a transparent matrix that could be published on the PCAOB's website. We encourage the PCAOB to integrate such steps into its standard setting process to allow commenter's to better understand a proposal and the inter-relationships that may exist with current standards and other proposals. Additionally, the questions posed in the release text for comment do not lend themselves to broad public input without a better articulation by the PCAOB of the issues it seeks to address, along with their pros and cons, relevant considerations, and potential consequences.

[4] The CCMC expressed similar concerns to the Securities and Exchange Commission ("SEC") regarding a proposal on Proxy Access, see June 20, 2009 letter to the SEC on Facilitating Shareholder Director Nominations. The proposal was eventually released for a second comment period.

Finally, the CCMC believes that a lack of transparency with the PCAOB's standard setting process deprives the public of an understanding of the PCAOB's proposals and overall direction in achieving effective audit policy goals. Ostensibly, the PCAOB attempts to solve this issue by using release text in conjunction with proposing or adopting a standard. The CCMC is concerned, as we have written before, that release text is often used, without public explanation or input, to modify the standard or undermine its intent. Release text has merit, particularly in exposure drafts of proposed standards, as it can facilitate better public input. Nonetheless, since release text in any final standard will be referenced by plaintiff attorneys, PCAOB inspectors, and other regulators as a touchstone for the PCAOB's intent, we encourage the PCAOB to be very cautious and transparent in crafting release text for adopted standards.

2. Convergence of Auditing Standards

The CCMC, along with a number of other groups both domestic and international, support efforts to converge auditing standards.[5] Financial reporting convergence for global standards even received significant attention during the G-20 summit in Pittsburgh.

We appreciate that the PCAOB has included (as Appendix 10) a comparison of the proposed auditing standards to the objectives and requirements of the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants. However, in many instances, the comparisons fall short of explaining whether the PCAOB views its proposed standards as being different from those of the IAASB and ASB and, if so, the rationale for such differences and what is intended to be accomplished by the PCAOB's proposal.

In addition, by taking this approach, the PCAOB again fails to acknowledge the globalization of the economy and the unique needs these changes have imposed upon businesses and investors alike. Commonalities in the dissemination, reliability, and evaluation of financial information assist in the sound operation of markets. With this

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[5] For example, see letters from the United States Chamber of Commerce's Center for Capital Markets Competitiveness on PCAOB rulemaking docket matter No. 026, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (February 18, 2009), on PCAOB rulemaking docket matter No. 025, *Proposed Auditing Standard on Engagement Quality Review*, and on SEC File Number PCAOB-2009-02, *Auditing Standard No. 7 – Engagement Quality Review.*

proposal, the PCAOB has missed another opportunity to advance the convergence of international auditing standards.

The CCMC again calls for the PCAOB to make audit convergence a priority and to take up the leadership mantle in making this goal a reality.

3. Disclosure

The proposed standards include an expanded list of new requirements related to disclosure in the planning and conduct of public company audits. As such, the proposed standards sprinkle guidance throughout auditing standards that would collectively supersede AU Section 431, *Adequacy of Disclosure in Financial Statements.* The release text explains the PCAOB believes that enhancing the requirements for evaluating disclosures can prompt auditors to be more thoughtful and thorough in their approach to testing and evaluating disclosures. Unfortunately, the PCAOB has not provided clarity around the nature and substance of these enhancements or the need for each. As such, it is difficult to determine the PCAOB's intent.

This is troubling because the PCAOB's proposals are not conditioned upon the existence of a framework or guidance on the nature of audit judgments around disclosures under generally accepted accounting principles ("GAAP"). Yet such judgments on disclosure, by their nature, are integrated with the auditor's consideration of accounting requirements under GAAP. In addition, the PCAOB seems to be emphasizing qualitative aspects of disclosures.[6] Unstated is whether the PCAOB is somehow expecting auditors to assess whether companies have disclosed qualitative information in a transparent and understandable manner – a topic of discussion at the October 14-15, 2009 SAG meeting, but a topic which the PCAOB noted at the time went well beyond existed auditing standards.

Importantly, these issues only reinforce the need for the PCAOB to take action on the recommendation of the SEC's Advisory Committee on Improvements to Financial Reporting ("CIFiR") for the PCAOB to "develop and articulate guidance related to how the PCAOB, including its inspections and enforcement divisions,

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[6] One example of the confusion created by this emphasis is the note that has been added to paragraph 7 (pp. A3-2-3) of the proposed standard on *Consideration of Materiality in Planning and Performing an Audit*, which singles out related party transactions as an example of circumstances where qualitative factors could render quantitatively immaterial accounts or disclosures material.

would evaluate the reasonableness of judgments made based on PCAOB auditing standards." As accounting judgments encompass disclosures, it is likewise noteworthy that CIFiR recommended the PCAOB's statement of policy should acknowledge that the PCAOB would look to the SEC's statement of policy to the extent the PCAOB would be evaluating the appropriateness of accounting judgments as part of auditor's compliance with PCAOB auditing standards."[7] Having such a policy statement on auditor judgments would provide a framework for the PCAOB to consider any necessary revisions to the Interim Standards such as these being proposed related to risk. Also, it would provide a context for others to consider and comment on any such proposed revisions.

4. Implementation of Auditing Standards

The release text of the proposals states that the PCAOB expects the final standards related to the auditor's assessment of and response to risk will be effective for audits of fiscal years beginning on or after December 15, 2010. This is a very ambitious target date given that the PCAOB needs to consider comments, revise the proposed standards, hold an open PCAOB meeting to adopt any final standards, and then send the adopted standards to the Securities and Exchange Commission ("SEC") for public comment and Commission approval before they can become effective. Moreover, the effective date for implementing the standards needs to have adequate lead-time to give audit firms an opportunity to make any necessary revisions in their audit methodologies and guidance and adequately train their people. Audit quality is not improved by rushing the implementation process.

The implications for the audit process of these standards on the auditor's assessment of and response to risk are pervasive. As a result, they likewise involve significant considerations relative to audit methodologies and auditor training around the world. Thus, the example provided by AS No. 7, *Engagement Quality Review*, where the standard was approved by the SEC *after* its effective date, does not provide an appropriate model for implementing these foundational standards. The CCMC encourages the PCAOB and the SEC to work together and consider realistic effective dates for the implementation of these, as well as other, new PCAOB auditing standards.

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[7] *The Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission*, August 1, 2008, p. 93.

5. Conclusion

For the foregoing reasons, the CCMC believes that it is in the best interests of financial reporting policy that this proposal be withdrawn, re-evaluated and improved. We stand ready to work with you in that worthwhile endeavor.

Sincerely,

Tom Quaadman

GAO
Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

March 2, 2010

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Subject: PCAOB Rulemaking Docket Matter 026: PCAOB Release No. 2009-007: *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) proposed new auditing standards on assessing and responding to risk during an audit.

We appreciate the PCAOB's efforts to update its auditing standards on assessing and responding to audit risk for registered companies and agree that this process is a critical element of an effective audit. The new proposed standards are an improvement from the audit risk standards originally proposed by PCAOB. In particular, the Appendix 10 comparison of the new proposed standards to the analogous standards of International Auditing and Assurance Standards Board (IAASB) and the Auditing Standards Board (ASB) and the Appendix 9 discussion of PCAOB's new proposed auditing standards and comments on original standards proposed in October 2008, provide important information regarding the differences between the different standards that firms need to implement.

Consistent with our February 18, 2009 letter commenting on the original proposed standards, we continue to have serious concerns about the PCAOB's approach to updating its interim standards by revising or supplementing certain core interim standards with new standards developed by the PCAOB, resulting in duplication of and inconsistencies between its standards and those of other established independent auditing standard-setting organizations. These new PCAOB standards include, in some cases, modified versions of other established standards without providing clear explanations of the reasons for or meaning of those differences. This approach will increase the likelihood of misinterpretations, inconsistent application of the standards, and higher costs for all users with a disproportionate burden on smaller and mid-sized firms. We strongly believe auditing standard setters should work together to achieve core auditing standards that are universally accepted. Where there is a clear and compelling reason, the individual standard-setting bodies should develop additional, incremental standards and requirements necessary to meet the needs of their respective constituencies. The nature of any differences from core auditing standards and the basis for the differences also should be clearly communicated.

Although Appendice 10 provides information to help users recognize differences between PCAOB standards and the International Standards on Auditing (ISA), we find its usefulness limited by inadequate explanations of (1) the reasons for differences between the new proposed PCAOB standards and international standards and (2) the changes in practice that are expected to result from these differences.

For example, Appendix 10, *Comparison of the Objectives and Requirements of Proposed Auditing Standards to the Analogous Standards of the IAASB and ASB*, identifies differences between PCAOB's new proposed standards and the ISAs, but it is not consistent in explaining why the differences are necessary. For a few of the differences very good explanations are provided. For instance, on page A10-6, the explanation for divergent materiality definitions and requirements states that establishing materiality for audits of U.S. public companies differs from the ISA standard because, "… the requirement in the proposed standard is based on the concept of materiality that is articulated by the Supreme Court of the United States in interpreting the federal securities laws." Other explanations in Appendix 10, though, are not as well developed. On pages A10-9 and A10-10, a description is provided of additional PCAOB requirements regarding obtaining an understanding of the company and its environment, but no reason is given to explain why these requirements are necessary in audits of U.S. public companies. The lack of an explanation for the differences could cause confusion for readers, who may not understand the PCAOB's intention in proposing the new requirements.

In other instances, Appendix 10 cites requirements adapted from existing PCAOB standards as justification for divergence from the ISAs, implying that existing PCAOB standards, including the interim standards, need no additional explanations for divergences from the ISAs. For example, on pages A10-5 and A10-6, in discussing requirements related to supervision, the document notes that "these requirements are adapted from existing PCAOB standards…" A similar notation is included on page A10-7 in the discussion of the requirements for determining tolerable misstatement. By failing to explain the reason for retaining the existing standard rather than converging with the ISAs, readers may be left to wonder if the ISA requirements are not relevant in a public company audit or if the PCAOB intends to address the divergence in the future.

While Appendix 9 provides information to help users identify changes to existing PCAOB standards, it also indicates that the PCAOB is trying to correct practice problems through the standards when this is not always appropriate. For example in

Appendix 9 on pages A9-68 and A9-69, the changes to AU sec. 329, Analytical Procedures, are explained by noting that the section was revised to focus solely on substantive analytical procedures and accordingly would be re-titled Substantive Analytical Procedures. The explanation further notes that “A standard that focuses solely on substantive analytical procedures would highlight more clearly the requirements that apply to analytical procedures performed for that purpose. The Board has observed instances in which auditors performed substantive procedures to test accounts without meeting the requirements in AU sec. 329 for substantive analytical procedures.” It is unclear how these changes to the standard will increase auditors’ compliance with the standards in practice.

In order to make the proposed standards easier for users to understand and apply, and to improve consistency of application, we recommend that, in addition to identifying differences between proposed standards and corresponding international standards, the PCAOB supply reasoned, logical explanations for all significant differences from the ISA requirements along with the objectives of the differences, e.g.: the desired changes in practice. When the PCAOB chooses not to converge with ISA requirements, an explanation should provide details of why the PCAOB’s approach is appropriate in audits of public companies. When the PCAOB proposes differences from international standards to correct practice problems, it should identify (1) the practice problem and (2) how the difference is intended to change practice.

We thank you for considering our comments on these important issues.

Sincerely yours,

Jeanette M Franzel

Jeanette Franzel

Managing Director

Financial Management and Assurance

NOTICE: This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on April 8, 2010 that related to the Board's proposed auditing standards related to the auditor's assessment of and response to risk. The other topics discussed during the April 8, 2010 meeting are not included in this transcript excerpt.

The Public Company Accounting Oversight Board does not certify the accuracy of this unofficial transcript. The transcript has not been edited and may contain typographical or other errors or omissions. An archive of the webcast of the entire meeting can be found on the Public Company Accounting Oversight Board's website at:
http://pcaobus.org/News/Events/Pages/04072010_SAGMeeting.aspx.

MR. BAUMANN: Okay, thank you. Well, the final item on our agenda, as we move towards a close, as I mentioned, the proposed and then re-proposed standards on the auditors identification of risk and the auditor's assessment and response to that risk. And these risk assessment standards that go right from planning and supervision, right through collecting of audit evidence, I think there are critical standards foundational in their nature to where our future standard setting goes.

Keith Wilson has been leading the project on the risk assessment standards. As I mentioned the comment period closed on March 2nd. Keith is working closely with the rest of the staff and with me, moving towards a final proposal of -- final issuance of those standards with a target for the third quarter.

Keith -- I've asked Keith to give an update on the comments that were received as part of the re-proposal.

MR. WILSON: Thank you, Marty. As he mentioned, my objective here is to brief you on the comments that we received so -- on the proposal, and not -- we're still in the process of analyzing them. So we don't have formal conclusions or recommendations to the board at this time, but we wanted to try and give you a bit of a sense of some of the comments that we've received.

I also should preface my remarks by saying that I realize that some of you around this table may have actually participated in drafting comment letters and providing those comments to us. The natural part of this process is we have to winnow some of them for this presentation. So you may not see every comment that you had placed in a comment letter, but please, rest assured that we are carefully looking at each and every comment. And we'll plan to make an appropriate response to those.

Before I actually get into the individual slides, let me just quickly for those who haven't been following this project as closely, give you a just a quick overview of the standards themselves, what's involved in this suite of seven, as some have called it. And then we'll move right into comments.

The first standard is standard on audit risk, which describes in general terms the components of audit risk and the auditor's consideration of audit risk in both from the assessment and the developing procedures to respond to risk.

Audit planning and supervision in the second standard, as the name implies, it describes the auditor's responsibilities for planning the audit and for supervising engagement team members. And that would include things like deciding which matters are important to audit planning, and setting an appropriate audit strategy and plan.

The third standard called consideration

of materiality in planning and performing an audit describes the auditor's responsibilities for applying the established concepts of materiality and planning the audit and performing audit procedures and determining in effect the scope of the audit.

The standard identifying and assessing risks of material misstatement describes the auditor's responsibilities for performing procedures to identify and assess the risks of material misstatement and the companion standard to that, the auditor's responses to the risk of material misstatement describes the responsibilities for developing overall responses to the way the engagement is conducted, as well as developing specific procedures to respond to the risks that have been identified.

Evaluating audit results is a standard that describes the process, the auditor's responsibilities for evaluating the evidence that they've obtained during the audit and determining whether or not they've obtained sufficient appropriate evidence to support their conclusions expressed in the auditor's report.

And finally, the standard on audit evidence talks more about the sufficiency, what sufficiency and appropriateness of audit evidence means and what procedures the auditor might perform to obtain that evidence.

All right. This time, we have -- we've received 23 comment letters down somewhat from the prior year. The profile here as we've described, there are 10 from auditing firms. There are -- we received six comment letters from what I call associations of accountance or firms. So that would be like state societies, three international associations of accountants, and the Center for Audit Quality.

The academics -- one of those commenters in the academic column is the Auditing Standards Committee for -- of the American Accounting Association. And then there was an individual academic.

In the last category, other includes

CALPERS, the Institute of Internal Auditors, the GAO, the U.S. Chamber of Commerce, and an individual who's apparently a consultant.

Just as a general observations, I would say that most of the commenters did acknowledge and recognize that there were improvements in the re-proposed standards as compared to the original standards. And I say that for two reasons. It was -- in some cases, the commenter specifically acknowledged improvements, supported some of the changes that we'd made affirmatively. And also, there was a substantial reduction in the number of comments in these -- to the re-proposal as compared to the original proposal.

In general, the themes that we saw in the comment letters were substantially the same as the comments that we received on the original proposal, but the specific comments may have changed.

So for example, one of the area -- the key objectives of this project, we were -- as been said, was to try and create better alignment between the standards for assessing and responding to risk and the board standard for auditing internal control over financial reporting, AS 5.

And there were a number of comments on the original proposal about suggesting ways to improve the alignment. And we made a number of changed in that area for the re-proposal. The commenters seem to -- some of them specifically supported those changes that we made in that area. And we really had a substantial reduction in the number of comments. I think the primary -- we had one commenter who suggested a number of amendments to AS 5 in light of the re-proposed risk assessment standards. But generally, there seem to be an acknowledgement that there is good alignment between the standards now.

Some -- we did have a number of commenters who continued to make statements about supporting -- reducing unnecessary differences with the standards of the IAASB and the ASB. Some used words like "converage." Others, "align." Some said "reducing unnecessary differences," but all in that same sort of vein.

And some -- one area that we receive quite a bit of comment, and maybe the largest single area, in fact, was asking more information -- asking for more information, more explanation about how these re-proposed standards would affect audits. What were we expecting auditors to change? And what's the board's rationale? Just more information about those kinds of questions.

They -- the comments varied in terms of the types of specific information they wanted, the form of the information that they were looking for, but certainly that's an area that's going to require a lot of thinking and study on our part, in terms of coming up with a way to more effectively describe the changes that we would expect these standards to have on audits.

We had -- we did have some commenters that acknowledged that some changes that the board had made in the standard setting process, and efforts to improve transparency such as having a concept release, or in this case, a second proposal of the standards, so some of those -- and just some general observations about things that we've done in terms of publishing our agenda and keeping updated on that.

There were other -- a host of other recommendations on improving the standard setting process in general. Probably the most common was a recurring suggestion to use external tax forces in the process of drafting standards and various comments along those lines.

There were -- as a -- as been mentioned a couple of times already, one of the big areas of focus in this project was to try and integrate the requirements for the auditor to assess and respond to fraud risk as part of this risk assessment standards. And we -- on the original proposal, we received a number of comments about this. They were quite missed. Some were very supportive. Some had concerns. Some were neutral.

We had fewer comments this time, but we continued to receive some comments about that. And again, it's mixed. Some support it quite strongly. Some are more concerned about that approach.

And we did have -- I think has been mentioned at least a little bit, one of the important points of emphasis in the re-proposal as compared to the original proposal, is a number of new requirements related to -- they were intended to focus the auditor on the area of disclosures.

And so, in some of the standards, their requirements for -- as part of obtaining an understanding of the company and the environment to develop expectations, I'll say, of the types of disclosures that they had expect to see in the financial statements.

In terms of thinking about assessing risk or brainstorming about fraud risk, to think about ways that the financial statements might be misstated by omitting disclosures or providing incomplete disclosures. And then a more focused discussion in the standard on evaluating the financial statements, more discussion about specifically evaluating the disclosures in the financial statements.

Commenters generally supported the new

requirements. We did get some specific comments for requests for clarification about these -- the specific requirements that we had. And I'll discuss those as we get in the particular standards, but I think generally, commenters seem to be supportive of those additional requirements.

Training the specific standards, the audit risk standard, as I mentioned, it describes the individual components of audit risk, the risk that the financial -- that the auditor would issue an inappropriate opinion when the financial statements are materially misstated.

And we had some requests in the comments for some additional discussion about some of the points that we had covered in there.

For example, when we talked about risks at the financial statement level, the one had more discussion about how those kinds of risks would result in misstatement of the financial statements.

So for example, if there was a decline in the company's industry, how would that potentially result in material misstatement of the financial statements? They wanted the standard to talk about that more.

And also, to talk a little bit more about some of the points about how the auditor considers risk and develops procedures to respond to risk.

The planning and supervision standard, as the name suggests, and as the interim -- like the interim standard it would replace, covers both audit planning and supervision. And we received comments that along the lines of these are, in fact, separate topics. They may have some relationship, but they're really separate topics. So they ought to be in separate standards.

So if we follow those recommendations, I guess we would end up with a suite of eight standards instead of a suite of seven standards.

There were some comments about the role of the engagement partner and the responsibilities in here. And I guess by way of background, the standard starts off early on by saying that the engagement partner is responsible for the engagement and its performance. And therefore, they're responsible for planning and supervision, but they may seek assistance from other engagement team members.

From that point following in the standard, we use the word "auditor" in the standard to encompass both the engagement partner and others who are involved in the process. And there were some requests to lay out in the standard the linkage between the engagement partner and auditor responsibilities as we describe it in the standard.

One area that was a significant area of change relates to the scoping for multi location engagements. And that refers to how the auditor determines how much work to do at individual locations when there's a multi location engagement.

We had a number of commenters on the original proposal that essentially said you should align this -- these requirements more closely with AS 5. And you should make it more risk based.

So we did that. And there seemed to be support for that, but there were a couple of points that they wanted to -- that commenters called our attention to.

One is there's a specific requirement in the standard for varying the procedures at locations from year to year. That requirement parallels a similar requirement in AS 5. And commenters suggested that that was too prescriptive, it was unnecessary because we do have another standard that more generally requires the auditor to incorporate an element of unpredictability. And they were suggesting that this specific requirement could be made an example of the more general requirement in our standard.

There were also specific requests, going back to a topic that we covered -- that we talked about yesterday, the -- how would the requirements we have for scoping multi location engagements apply when there's another auditor involved? And specifically, when there's divided reporting responsibility kinds of situations?

So a request for at least an explanation, if not some kind of addition -- modified provisions to address those situations.

Another area that we made a significant change in the re-proposal versus the original proposal is in the area of considering the need for persons with specialized skill or knowledge.

The original proposal had said that -- it required the auditor to consider as part of planning whether or not they needed a person with specialized skill or knowledge in order to effectively conduct the audit in essence. And there were also -- there's also a requirement in there related to the knowledge that the core audit team needed of the subject matter in order to effectively deal with the person with specialized knowledge or skill.

Some of the original requirements were framed in terms of IT specialists, because that was what the -- our existing standard frames the requirement. We had a lot of comments to the original proposal that said broaden it to include anyone with specialized skill or knowledge. And we did that. And so, we seem to get support for that change.

They did have -- and there were a couple of drafting suggestions for it, but one -- commenters also took the opportunity to provide some of their views on when someone -- when a specialist should be under the general requirements for supervision versus when they should be under a separate standard for using an auditor specialist.

So some of those, we're going to analyze those comments. Some of them may be more applicable to the separate specialist project. And if they don't get picked up and addressed as part of this project, certainly they would be something we would consider in the follow-on specialist project.

A -- and on the standard on materiality, there were three significant changes to that -- to the re-proposal, which sparked comments.

The first was a change in the articulation of the concept of materiality. The original proposal we had used a quotation that existed in our existing interim standard, that is from a FASB Concept Statement number 2, that describe materiality. And we had a footnote that referenced the applicable interpretation of the federal courts in interpreting the securities -- federal securities laws.

And during the intervening time between the original proposal and the re-proposal, of course, FASB released its codification, which as you know, doesn't include the concept statements. So that caused us to pause and reflect on this discussion. And what we came back to was actually the standard that does apply in these situations, which is the standard that's articulated by the courts.

So our standard now says -- now uses the articulation from the federal court decision that states a fact is material if there's substantial likelihood that the fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.

So in re-proposal, that's the articulation that we use. And it -- because it is in fact the standard as I mentioned that's used. And it does also make clear that the concept of materiality that applies here should reflect the perspective of a reasonable investor.

And comments on this area ranged from some requests for some additional discussion about how this concept is applied in an accounting sense, to some actual just concerns about using a court -- language from the federal courts in an auditing standard.

Another area that drew some comment, we included another sentence in the standard -- the standard requires that when planning the audit, the auditors should establish a materiality level for the financial statements that's appropriate in light of the particular circumstances. And we'd added a statement that said that this includes consideration of the company's earnings and other relevant factors. That was really intended to be just an acknowledgement of the fact that typically, for these kinds of companies, earnings is the most significant factor.

But we did have some commenters asking questions along the lines of well, does that mean you always have to use earnings? Does earnings -- is that required universally in each case? Is our intention -- what did we mean by other relevant factors. So really, that's more asking for I would say clarification on that point.

Then another area that was a change in the re-proposal was we added specific provisions related to determining materiality for -- in multi location audits at the individual component level. So determining the materiality at an individual business unit or location.

And the -- there was a general principle articulated in the requirement to say that the materiality at that individual location or component level cannot exceed and generally should be less than materiality for the financial statements as a whole.

And we received some generally favorable comments for adding this requirement, but there were some requests, again, for specific additional clarification on, for example, how you would apply this again in a divided reporting scenario when there was another auditor involved.

In the identifying and assessing risks of material misstatement standard, we have received -- continued to receive comments on a requirement to consider performing additional procedures, which involve things such as reading public information about the company, such as analyst reports, reading transcripts of earnings calls, obtaining information about trading activity in the company's securities by significant holders to identify potentially significant unusual developments.

And most of the comments in this area are really around scope, what are the expectations? Do we expect auditors to go out and track down every single piece of publicly available information about the company and affirmatively document that and check off do we intend for them to look at it or not?

So this, again, is another example of trying to provide some requests for clarification about what the expectation of performance is.

Then for the areas where -- the requirements that I mentioned about obtaining and understanding about necessary financial statement disclosures and some of those requirements that want -- the commenters asked us to be sure to clarify that we're talking about evaluating disclosures in the context of the applicable financial reporting framework.

And there were -- in the area of obtaining an understanding of internal control over financial reporting, we have -- in order to determine how -- the extent of the understanding that's needed, the standard outlines certain objectives that the auditor needs to meet overall. And that's suppoed to guide the auditor through the process of determining for each component of internal control, how much information that they need. There's still some -- in the area of when we get down to control activities, there's some concern about whether or not -- what our expectations are in terms of how much understanding of control activities there are? Are we intending the auditor to look at all control activities? Or are we really intending there to be a significant change in practice related to that. So again, a request for clarification on that point.

And then finally, on this standard, the -- we have a requirement, which really is carried forward from our existing requirements for the auditor to consider information obtained from other engagements.

And that information, we had two types of comments on that requirement.

MALE SPEAKER 1: That's other engagements for the issuer.

MR. WILSON: Yes, other engagements for the company. Yes. And they -- some people felt like this was too broad. And there were suggestions to either go back and use some additional language that's in our existing requirement, or to alternatively frame this in terms of the engagements performed by the engagement partner, as opposed to by the firm.

So those -- that would, in fact, if we went to engagement partner, that would in fact be a change from our existing standards and our existing requirement.

For the auditor's response standard, there are requirements -- we spent a good bit of time here in trying to frame the auditor's responsibilities around using information from prior audits to -- in the evaluation of the effectiveness of controls. And we have like in some respects AS 5, this standard requires the auditor to obtain evidence each year about controls that they're going to rely on.

But it does allow the auditor to use evidence from prior year and information about risk in determining how much additional information they need in the current year.

And so, we had comments on this requesting that we add some additional language to make clear that this could be -- that the information from prior year could inform the auditor's risk assessments, which in turn drives the extent of evidence needed in the current year.

And in the area of -- there were -- we have requirements related to situations in which the auditor performs substantive testing at year-end -- at an interim date. For example, in a calendar year-end audit, they might test accounts receivable at October 31. And we have requirements that really are adapted from our existing requirements about going and updating the auditor's conclusions from that interim date to year-end.

And what the standard requires the auditor to perform procedures to cover the remaining period that would provide a reasonable basis for extending those conclusions.

And then we have some specific procedural requirements that need to be included as part of that work, which again, are carried forward from our existing standard. It was the -- we did get comments and some of the commenters indicated that those specific additional requirements weren't necessary and that we should just go with the more general requirement about performing procedures that provide a reasonable basis.

In the evaluating audit result standard, we had -- our reproposed standard requires the auditor to accumulate misstatements that they find, other than those that are essential de minimus. And if they're uncorrected, to communicate those to management. And if management does not correct them, to evaluate the reasons why as part of their assessment of bias.

There were some commenters asked us to also include a specific requirement for the auditor to request management to correct the uncorrected misstatements. And we received that comment on the initial proposal. Our reaction was that there are already existing requirements for management to do that, that it was unnecessary for us to put in an auditing standard to specifically require the auditor to ask management to correct those, but we nevertheless received additional comments that we should have such a requirement in the standard.

We have a requirement -- another area -- we have a requirement in the area of evaluating uncorrected misstatements. We have an existing requirement to -- and carried forward in these standards, to evaluate the effects of uncorrected misstatements detected in prior years and misstatements detected in the current year that relate to prior years as part of the overall evaluation of uncorrected misstatements. And some commenters wanted us to include a specific cross reference to SEC Staff Accounting Bulletin Number 108 on the subject of considering the effects of prior year misstatements. So a number of commenters suggested that we add that reference.

Then the last point on this -- in this area was a recommendation, again, as I mentioned that we have specific additional requirements for evaluating disclosures as part of the evaluating the presentation of the financial statements, and specifically, evaluating whether the financial statements include all the required disclosures.

And we had some commenters that requested that we be sure and make a qualification to this requirement, based on materiality.

The audit evidence standard, there were requests for additional explanation about put sufficiency and appropriateness of audit evidence means. And some said create some specific definitions of sufficiency and appropriateness to include as part of the standard. Another said that sometimes in our standards, we use the word persuasive or persuasiveness. Please provide an explanation of how persuasiveness relates to sufficiency and appropriateness. So we receive those kinds of comments.

In the area of amendments to PCAOB standards, the reproposal included some specific additional documentation requirements that weren't in the original proposal. Some of them related to things such as documenting the risk assessment procedures and the responses to the risks, including a summary of identified risk, the auditor's assessment of the risks at the financial statement and assertion levels and the auditors responses, showing the linkage between the risk assessments and the responses.

And we had some commenters -- we had a couple commenters that said that this requirement itself was too prescriptive. Others just questioned whether we should be -- we had proposed this as an amendment to AS 3. Some had suggested that it actually was more appropriate to put these kind of documentation requirements in the respective standards.

And finally, in the area of -- in our -- we had proposed an amendment to the audit sampling standard. And it relates to sample sizes when an auditor's using non statistical sampling methods. And the requirement would say that when a non statistical sampling method is applied properly, the resulting sample size ordinarily will be comparable to or larger than the sample size resulting from an efficient and effectively designed statistical sample.

And we explained in the release that the intent is not that you calculate a statistical sample and a non statistical sample size. The idea is that recognizing that a number of firms already have methodologies to accomplish this, that were derived from statistical sampling methods that they could just use those. And the idea was to point to that, as opposed to just saying I'll pick three, because -- based on my professional judgment, but to put some more rigor around the process of considering what an appropriate sample size was.

We had requests to put in some qualifiers to specifically say in the standard that we are not intending for auditors to calculate sample sizes under both methods.

So that concludes my remarks on the comments that we received so far. And I suppose we have a couple minutes, if anyone has questions or comments, wants to react to that.

Oh, Doug, come up.

MR. CARMICHAEL: Yeah, just comment. And I -- whenever I bring this up, boy, say well, it's not a problem because management today is correcting all the misstatements that the auditor proposes anyway.

But I think it'd be a good idea to

reinforce the point from the Sarbanes Oxley Act that management is required to correct all material adjustments that the auditor proposes just to remind people of that.

MR. WILSON: That's a good point. Thanks.

MR. BAUMANN: Okay, well, thank you very much. Keith, thanks for that summary. We did that because as I've said on numerous occasions, I think these seven standards are very important for the performance and execution of an audit. And they are adding to the framework that already exists under PCAOB standards, and will be foundational for future standard setting.

Our goal, as I mentioned earlier, and it is a goal, it's a lot of work here, is to try to address all of these comments and try to issue these standards during the third quarter.

Meeting of the Standing Advisory Group

April 8, 2010

8:30 a.m. – 12:30 p.m.

Risk Assessment- Summary of Comments Received

Keith Wilson
Associate Chief Auditor,
Office of the Chief Auditor

Risk Assessment

- Profile of Commenters

Auditing firms	10
Associations of accountants/firms	6
Academics	2
Other	5
Total	23

PCAOB Public Company Accounting Oversight Board

General Observations

- Most commenters recognized improvements in the reproposed standards and release
- Overall themes in the comment letters were substantially the same as the comments on the original proposal, with some changes to the specific recommendations
- Some commenters continued to support reducing unnecessary differences with standards of the IAASB and ASB
- Some commenters requested more detailed information in the release, including more explanation about how the re-proposed standards would affect audits

PCAOB Public Company Accounting Oversight Board

General Observations

- Some commenters offered recommendations regarding the Board's standards-setting process, e.g., specific measures to increase transparency in the process and use of task forces in drafting standards
- A few commenters expressed their views on the integration of fraud considerations into the risk assessment standards
- Some commenters expressly supported the new requirements regarding consideration of disclosures, and a few requested clarifications regarding some of those requirements

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Comments on Specific Standards

- Audit Risk
  - Requests for clarification or additional explanation of the components of audit risk
- Planning and Supervision
  - Recommendations to divide the standards into separate standards for planning and for supervision
  - Requests for clarification of the role of the engagement partner for supervision and review

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Public Company Accounting Oversight Board

Comments on Specific Standards

- Planning and Supervision (cont'd)
  - Regarding the requirements for multi-location engagements:
    - Concerns that the requirements for varying procedures at locations year to year is too prescriptive
    - Requests for direction on applying the requirements to situations when the work and reports of other auditors are used
  - General support for the provisions regarding persons with specialized skill or knowledge, with a variety of recommended enhancements

PCAOB

Comments on Specific Standards

- Consideration of materiality in Planning and Performing an Audit
  - Concerns regarding the use of the federal courts' description of the concept of materiality
  - Requests for clarification regarding the new statement about considering the company's earnings and other relevant factors in making judgments about materiality
  - General support for the provision for determining materiality in multi-location engagements, and requests for explanation about how to apply certain aspects of the new provision for multi-location engagements

PCAOB

Comments on Specific Standards

- Identifying and Assessing Risks of Material Misstatement
  - Requests for clarification of the requirement to consider performing certain procedures while obtaining an understanding of the company, amid concerns that a broad interpretation of the requirements could be unduly burdensome
  - Requests for clarification of certain requirements regarding consideration of necessary financial statement disclosures
  - Requests for clarification of the requirements for obtaining an understanding of control activities
  - Concerns that the wording of the requirement to consider information from other engagements performed for the company was too broad

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Comments on Specific Standards

- Auditor's Responses to the Risks of Material Misstatement
  - Requests for additional clarification of the requirements regarding the use of evidence from past audits when evaluating the effectiveness of controls
  - Concerns that the requirements for updating procedures when substantive tests were performed at an interim date are too prescriptive

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Comments on Specific Standards

- Evaluating Audit Results
  - Recommendation to require auditors to request that management correct all misstatements
  - Recommendation to include a reference to SEC Staff Accounting Bulletin 108 in the discussion of evaluation of misstatements
  - Recommendation that the requirement for evaluating disclosures be qualified based on materiality

PCAOB

Comments on Specific Standards

- Audit Evidence
  - Requests for more explanation of the concepts of "sufficiency" and “appropriateness" of audit evidence
- Amendments to PCAOB standards
  - Auditing Standard No. 3, *Audit Documentation* (AS 3): recommendation that amendments be placed in the respective risk assessment standards instead of AS 3
  - AU sec. 350, *Audit Sampling:* requests for clarification regarding new requirements for sample sizes when nonstatistical sampling methods are used

PCAOB

1666 K Street, NW
Washington, D.C. 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8430
www.pcaobus.org

AUDITING STANDARDS RELATED TO THE AUDITOR'S ASSESSMENT OF AND RESPONSE TO RISK AND RELATED AMENDMENTS TO PCAOB STANDARDS	PCAOB Release No. 2010-004 August 5, 2010 PCAOB Rulemaking Docket Matter No. 026

Summary: After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") is adopting eight auditing standards related to the auditor's assessment of and response to risk that will supersede six of the Board's interim auditing standards and related amendments to PCAOB standards. The eight auditing standards and related amendments will be applicable to all registered firms conducting audits in accordance with PCAOB standards.

Board Contacts: Keith Wilson, Deputy Chief Auditor (202/207-9134, wilsonk@pcaobus.org), Jessica Watts, Associate Chief Auditor (202/207-9376, wattsj@pcaobus.org), Hasnat Ahmad, Assistant Chief Auditor (202/207-9349, ahmadh@pcaobus.org), Diane Jules, Assistant Chief Auditor (202/207-9111, julesd@pcaobus.org), and Hong Zhao, Assistant Chief Auditor (202/207-9355, zhaoh@pcaobus.org).

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I. Introduction

The Board is adopting eight auditing standards and related amendments that benefit investors by establishing requirements that enhance the effectiveness of the auditor's assessment of and response to the risks of material misstatement in an audit.

In an audit performed in accordance with PCAOB standards, risk underlies the entire audit process, including the procedures that the auditor performs to support the opinion expressed in the auditor's report. Most of the Board's interim auditing standards relating to assessing and responding to risk in an audit of financial statements were developed in the 1980s.[1/] Those standards described in general terms the auditor's responsibilities for assessing and responding to risk. They directed auditors to vary the amount of audit attention related to particular financial statement accounts based on the risks presented by them. The standards also allowed the auditor to use tests of controls to reduce substantive testing.[2/]

A number of factors and events led the Board to reexamine those standards and seek to improve them. These included the widespread use of risk-based audit methodologies; recommendations to the profession on ways in which auditors could improve risk assessment;[3/] advice from the Board's Standing Advisory Group ("SAG");[4/] adoption of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*; and observations from the Board's oversight activities.

On October 21, 2008, the Board proposed a set of auditing standards to update the requirements for assessing and responding to risk in an audit ("the original proposed standards").[5/] The original proposed standards were intended to improve the auditing standards and to benefit investors by establishing requirements that enhance the effectiveness of auditors' assessment of and response to risk through:

- Performing procedures that provide a reasonable basis for identifying and assessing risks of material misstatement, whether due to error or fraud

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1/ Examples of those standards include AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, and AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit.*

2/ AU sec. 319.

3/ See, e.g., Public Oversight Board, Panel on Audit Effectiveness ("PAE"), *Report and Recommendations* (August 31, 2000). For a summary of the PAE's recommendations related to risk assessment, see PCAOB Standing Advisory Group ("SAG") Meeting Briefing Paper, "Risk Assessment in Financial Statement Audits" (February 16, 2005), Appendix A, available at: http://www.pcaobus.org/News_and_Events/Events/2005/02-16.aspx.

4/ Webcasts of SAG meetings are available on the Board's Web site at: http://www.pcaobus.org/News_and_Events/Webcasts.

5/ PCAOB Release No. 2008-006, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (October 21, 2008).

- Tailoring the audit to respond appropriately to the risks of material misstatement

- Making a comprehensive evaluation of the evidence obtained during the audit to form the opinion(s) in the auditor's report

The Board also sought to emphasize the auditor's responsibilities for consideration of fraud by incorporating requirements for identifying and responding to the risks of material misstatement due to fraud ("fraud risks") and evaluating audit results from the existing PCAOB standard, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*[6/] Incorporating these requirements makes clear that the auditor's responsibilities for assessing and responding to fraud risks are an integral part of the audit process rather than a separate, parallel process. It also benefits investors by prompting auditors to make a more thoughtful and thorough assessment of fraud risks and to develop appropriate audit responses.

Improvements in the standards related to risk assessment also should enhance integration of the audit of financial statements with the audit of internal control over financial reporting ("audit of internal control") by articulating a process for identifying and assessing risks of material misstatement that applies to both portions of the integrated audit when the auditor is performing an integrated audit.

Many commenters on the original proposed standards were supportive of the Board's efforts to update its risk assessment requirements and offered numerous suggestions for changing the original proposed standards. After considering all of the comments received on those standards, the Board made numerous refinements to the original proposed standards. Because the standards address many fundamental aspects of the audit process and are expected to serve as a foundation for future standards-setting, the Board reproposed the standards for public comment on December 17, 2009 ("the reproposed standards").[7/]

[6/] Paragraphs .14-.51 and paragraphs .68-.78 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

[7/] PCAOB Release No. 2009-007, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (December 17, 2009).

The Board received 23 comment letters on the reproposed standards.[8/] The Board discussed the comments received with the SAG on April 8, 2010.[9/] Most commenters were generally supportive of the reproposed standards and the improvements made to those standards. Many commenters also offered suggestions to improve the standards, which the Board has carefully analyzed.

After consideration of the comments received, the Board has refined the standards to provide additional clarity. The Board has decided to adopt the following standards for assessing and responding to risk in an audit and the related amendments to PCAOB standards:

- Auditing Standard No. 8, *Audit Risk*
- Auditing Standard No. 9, *Audit Planning*
- Auditing Standard No. 10, *Supervision of the Audit Engagement*
- Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*
- Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*
- Auditing Standard No. 14, *Evaluating Audit Results*
- Auditing Standard No. 15, *Audit Evidence*

Appendices 1-8 of this release present the auditing standards, and Appendix 9 presents the related amendments to PCAOB standards.

[8/] Comments on the original proposed standards and the reproposed standards are available on the Board's Web site at: http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx.

[9/] A transcript of the portion of the meeting that related to the reproposed standards is available on the Board's Web site at: http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx.

II. Notable Areas of Change in the Standards

The changes made to the reproposed standards reflect refinements rather than significant shifts in approach. This section describes the areas of change to the reproposed standards that are most notable, e.g., because they affect multiple standards or multiple sections of an individual standard. Appendix 10 discusses these and other changes in more detail.

A. Planning and Supervision Standards

The reproposed standards included a standard covering both audit planning and supervision. Some commenters observed that audit planning and supervision should be covered in separate standards.

Audit planning and supervision, although related in some respects, are distinct activities that should be presented in separate standards. Accordingly, the Board has divided the planning and supervision standard into separate standards for planning and for supervision. Presenting the requirements for planning and supervision in separate standards is a technical change that, by itself, does not affect the auditor's responsibilities for planning the audit or supervision of the work of engagement team members as described in the reproposed standards.

B. Requirements for Multi-location Audits

The reproposed standard on audit planning and supervision included requirements regarding establishing the scope of testing of individual locations in multi-location engagements. The reproposed standard on consideration of materiality in planning and performing an audit included requirements for determining materiality of individual locations in multi-location audits. Some commenters requested clarification on the Board's expectations regarding how to apply those requirements in audits in which part of the work is performed by other auditors, specifically, auditors of financial statements of individual locations or business units that are included in the consolidated financial statements.

The multi-location requirements have been revised to take into account situations in which part of the work is performed by other auditors.[10/] Appendix 10 discusses those revisions in more detail and explains the Board's expectations regarding how to apply the respective requirements in situations involving other auditors.

[10/] Paragraphs 11-14 of Auditing Standard No. 9, *Audit Planning,* and paragraph 10 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit.*

The reproposed standard on audit planning and supervision also included a statement, similar to a statement in Auditing Standard No. 5, that "The direction in paragraph 5 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement,* regarding incorporating an element of unpredictability in the auditing procedures means that the auditor should vary the nature, timing, and extent of audit procedures at locations or business units from year to year." Some commenters stated that the statement in the reproposed audit planning and supervision standard was unnecessarily prescriptive. After considering the comments received, the requirement regarding unpredictability was removed from the audit planning standard, and the discussion in Auditing Standard No. 13 regarding incorporating an element of unpredictability was expanded to include varying the testing in the selected locations.[11/] However, this does not change the requirements in Auditing Standard No. 5 regarding incorporating unpredictability in testing controls at individual locations in audits of internal control.[12/]

C. Requirement for Performing Walkthroughs

In the original proposed standards, the standard on identifying and assessing risks of material misstatement referred auditors to Auditing Standard No. 5 for a discussion of the performance of walkthroughs. Some commenters on the original proposed standards stated that the proposed standard should include a discussion of walkthroughs rather than referring to Auditing Standard No. 5. The reproposed standard on identifying and assessing risks of material misstatement included a discussion of the objectives for understanding likely sources of potential misstatements and of performing walkthroughs, which paralleled a discussion in Auditing Standard No. 5.[13/] Some commenters expressed concerns that those new requirements would lead to unnecessary walkthroughs, particularly in audits of financial statements only.

The intention of including the discussion of walkthroughs was to describe how to perform walkthroughs, not to impose additional requirements regarding when to perform walkthroughs. The discussion has been revised to focus on how the auditor should perform walkthroughs, and the discussion of the objectives for understanding likely

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[11/] Paragraph 5 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

[12/] Paragraphs 61 and B13 of Auditing Standard No. 5.

[13/] Paragraph 34 of Auditing Standard No. 5.

sources of potential misstatements has been removed.[14/] Consequently, the objectives in paragraph 34 of Auditing Standard No. 5 for understanding potential sources of likely misstatement will continue to apply only to integrated audits.

D. Requirements Regarding Financial Statement Disclosures

Because of the importance of disclosures to the fair presentation of financial statements and based on observations from the Board's oversight activities, the reproposed standards included additional requirements intended to increase the auditor's attention on the disclosures in the financial statements. For example, the reproposed standard on identifying and assessing risks of material misstatement included a new requirement related to developing an expectation about the necessary financial statement disclosures as part of obtaining an understanding of the company and its environment. Some commenters stated that the requirements should be clarified as applying to disclosures required by the applicable financial reporting framework. Also, the reproposed standard on evaluating audit results included expanded requirements for the auditor to evaluate whether the financial statements include the required disclosures. Some commenters stated that the standard should clarify that the requirements apply only to material disclosures.

After analyzing the comments, those two requirements have been revised to clarify that they refer to the fair presentation of the financial statements in conformity with the applicable financial reporting framework.[15/]

III. <u>Additional Discussion of Standards and Comments</u>

Some commenters on the reproposed standards stated that the Board should provide more information about its requirements, including how the requirements are expected to affect audits. Commenters requested information about how the Board's standards compare to the standards of other standards-setters. Some commenters also requested more explanation for certain requirements in the Board's reproposed standards.

Appendix 10 of this release has been expanded to provide additional background for certain requirements in the Board's standards and further discussion of the Board's

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[14/] Paragraphs 37-38 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

[15/] Paragraph 13 of Auditing Standard No. 12 and paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.*

responses to comments, including the basis for its conclusions regarding certain requirements.

In analyzing comments on the appendix to the reproposed standards that compared the reproposed standards to the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants, the Board observed that a number of the explanations sought by commenters, e.g., the reasons for the differences in certain requirements, were discussed elsewhere in the release, e.g., in the appendix that provided additional discussion of comments.

Appendix 10 of this release discusses the principal rationale for the objectives and requirements in the standards being adopted today. Appendix 11 of this release discusses certain differences between the objectives and requirements of the PCAOB standards and the analogous standards of the IAASB and ASB. When a difference between the Board's standards and the analogous standards of the IAASB and ASB is noted, Appendix 11 contains a reference to the discussion of the Board's requirements in Appendix 10.

IV. Effective Date

The release accompanying the reproposed standards stated that the Board expects that the standards would be effective for audits of fiscal years beginning on or after December 15, 2010, subject to approval by the Securities and Exchange Commission ("SEC"), and the Board requested comment on the proposed effective date. Several commenters stated that the Board should establish sufficient time for auditing firms to make changes to their methodologies and train their staff on the new risk assessment standards.

After considering the comments received and the timing of the adoption of the standards, the Board has determined that the accompanying standards and related amendments will be effective, subject to SEC approval, for audits of fiscal periods beginning on or after December 15, 2010. In its determination, the Board considered that many auditors already employ risk-based audit methodologies, which should facilitate the methodology changes and training necessary to implement the standards by the effective date.

*   *   *

On the 5th day of August, in the year 2010, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Secretary

APPENDIX 1 – Auditing Standard No. 8 – *Audit Risk*

APPENDIX 2 – Auditing Standard No. 9 – *Audit Planning*

APPENDIX 3 – Auditing Standard No. 10 – *Supervision of the Audit Engagement*

APPENDIX 4 – Auditing Standard No. 11 – *Consideration of Materiality in Planning and Performing an Audit*

APPENDIX 5 – Auditing Standard No. 12 – *Identifying and Assessing Risks of Material Misstatement*

APPENDIX 6 – Auditing Standard No. 13 – *The Auditor's Responses to the Risks of Material Misstatement*

APPENDIX 7 – Auditing Standard No. 14 – *Evaluating Audit Results*

APPENDIX 8 – Auditing Standard No. 15 – *Audit Evidence*

APPENDIX 9 – Amendments to PCAOB Standards

APPENDIX 10 – Additional Discussion of Auditing Standards, Amendments to PCAOB Standards, and Comments on Reproposed Standards

APPENDIX 11 – Comparison of the Objectives and Requirements of the Accompanying PCAOB Auditing Standards with the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

APPENDIX 1

Auditing Standard No. 8

Audit Risk

Introduction

1. This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit[1/] or an audit of financial statements only.

Objective

2. The objective of the auditor is to conduct the audit of financial statements in a manner that reduces audit risk to an appropriately low level.

Audit Risk

3. To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement[2/] due to error or fraud. Reasonable assurance[3/] is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.

[1/] When the auditor is performing an integrated audit of financial statements and internal control over financial reporting, the requirements in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* also apply. However, the risks of material misstatement of the financial statements are the same for both the audit of financial statements and the audit of internal control over financial reporting.

[2/] Misstatement is defined in Appendix A of Auditing Standard No. 14, *Evaluating Audit Results*.

[3/] See AU sec. 110, *Responsibilities and Functions of the Independent Auditor,* and paragraph .10 of AU sec. 230, *Due Professional Care in the Performance of Work,* for a further discussion of reasonable assurance.

4. In an audit of financial statements, audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial reporting framework. Audit risk is a function of the risk of material misstatement and detection risk.

Note: The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

Risk of Material Misstatement

5. The risk of material misstatement refers to the risk that the financial statements are materially misstated. Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* indicates that the auditor should assess the risks of material misstatement at two levels: (1) at the financial statement level and (2) at the assertion[4/] level.[5/]

6. Risks of material misstatement at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of material misstatement at the financial statement level may be especially relevant to the auditor's consideration of the risk of material misstatement due to fraud. For example, an ineffective control environment, a lack of sufficient capital to continue operations, and declining conditions affecting the company's industry might create pressures or opportunities for management to manipulate the financial statements, leading to higher risk of material misstatement.

7. Risk of material misstatement at the assertion level consists of the following components:

a. *Inherent risk,* which refers to the susceptibility of an assertion to a misstatement, due to error or fraud, that could be material, individually or in combination with other misstatements, before consideration of any related controls.

[4/] See Auditing Standard No. 15, *Audit Evidence,* for a description of financial statement assertions.

[5/] Paragraph 59 of Auditing Standard No. 12.

b. *Control risk,* which is the risk that a misstatement due to error or fraud that could occur in an assertion and that could be material, individually or in combination with other misstatements, will not be prevented or detected on a timely basis by the company's internal control. Control risk is a function of the effectiveness of the design and operation of internal control.

8. Inherent risk and control risk are related to the company, its environment, and its internal control, and the auditor assesses those risks based on evidence he or she obtains. The auditor assesses inherent risk using information obtained from performing risk assessment procedures and considering the characteristics of the accounts and disclosures in the financial statements.[6/] The auditor assesses control risk using evidence obtained from tests of controls (if the auditor plans to rely on those controls to assess control risk at less than maximum) and from other sources.[7/]

Detection Risk

9. In an audit of financial statements, detection risk is the risk that the procedures performed by the auditor will not detect a misstatement that exists and that could be material, individually or in combination with other misstatements. Detection risk is affected by (1) the effectiveness of the substantive procedures and (2) their application by the auditor, i.e., whether the procedures were performed with due professional care.

10. The auditor uses the assessed risk of material misstatement to determine the appropriate level of detection risk for a financial statement assertion. The higher the risk of material misstatement, the lower the level of detection risk needs to be in order to reduce audit risk to an appropriately low level.

11. The auditor reduces the level of detection risk through the nature, timing, and extent of the substantive procedures performed. As the appropriate level of detection risk decreases, the evidence from substantive procedures that the auditor should obtain increases.[8/]

[6/] Paragraph 59.a. of Auditing Standard No. 12.

[7/] Paragraphs 32-34 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

[8/] Paragraph 37 of Auditing Standard No. 13.

PCAOB
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APPENDIX 2

Auditing Standard No. 9

Audit Planning

Introduction

1. This standard establishes requirements regarding planning an audit.

Objective

2. The objective of the auditor is to plan the audit so that the audit is conducted effectively.

Responsibility of the Engagement Partner for Planning

3. The **engagement partner**[1/] is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for planning the audit and may seek assistance from appropriate engagement team members in fulfilling this responsibility. Engagement team members who assist the engagement partner with audit planning also should comply with the relevant requirements in this standard.

Planning an Audit

4. The auditor should properly plan the audit. This standard describes the auditor's responsibilities for properly planning the audit.[2/]

5. Planning the audit includes establishing the overall audit strategy for the engagement and developing an audit plan, which includes, in particular, planned risk assessment procedures and planned responses to the risks of material misstatement. Planning is not a discrete phase of an audit but, rather, a continual and iterative process

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[1/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

[2/] The term, "auditor," as used in this standard, encompasses both the engagement partner and the engagement team members who assist the engagement partner in planning the audit.

that might begin shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit.

Preliminary Engagement Activities

6. The auditor should perform the following activities at the beginning of the audit:

a. Perform procedures regarding the continuance of the client relationship and the specific audit engagement,[3/]

b. Determine compliance with independence and ethics requirements, and

> Note: The determination of compliance with independence and ethics requirements is not limited to preliminary engagement activities and should be reevaluated with changes in circumstances.

c. Establish an understanding with the client regarding the services to be performed on the engagement.[4/]

Planning Activities

7. The nature and extent of planning activities that are necessary depend on the size and complexity of the company, the auditor's previous experience with the company, and changes in circumstances that occur during the audit. When developing the audit strategy and audit plan, as discussed in paragraphs 8-10, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures:

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;

[3/] Paragraphs .14-.16 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice.* AU sec. 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards,* explains how the quality control standards relate to the conduct of audits.

[4/] AU sec. 310, *Appointment of the Independent Auditor.*

- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality,[5/] risk, and, in integrated audits, other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee[6/] or management;
- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;
- Preliminary judgments about the effectiveness of internal control over financial reporting;
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;
- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and
- The relative complexity of the company's operations.

[5/] Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit.*

[6/] If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

Audit Strategy

8. The auditor should establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan.

9. In establishing the overall audit strategy, the auditor should take into account:

a. The reporting objectives of the engagement and the nature of the communications required by PCAOB standards,[7/]

b. The factors that are significant in directing the activities of the engagement team,[8/]

c. The results of preliminary engagement activities[9/] and the auditor's evaluation of the important matters in accordance with paragraph 7 of this standard, and

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7/ See, e.g., AU sec. 310 and AU sec. 380, *Communication With Audit Committees.* Also, various laws or regulations require other matters to be communicated. (See, e.g., Rule 2-07 of Regulation S-X, 17 CFR 210.2-07; and Rule 10A-3 under the Securities Exchange Act of 1934, 17 CFR 240.10A-3.) The requirements of this standard do not modify communications required by those other laws or regulations.

8/ See, e.g., paragraph 6 of Auditing Standard No. 10, *Supervision of the Audit Engagement*.

9/ Paragraph 6 of this standard.

d. The nature, timing, and extent of resources necessary to perform the engagement.[10/]

Audit Plan

10. The auditor should develop and document an audit plan that includes a description of:

a. The planned nature, timing, and extent of the risk assessment procedures;[11/]

b. The planned nature, timing, and extent of tests of controls and substantive procedures;[12/] and

c. Other planned audit procedures required to be performed so that the engagement complies with PCAOB standards.

Multi-location Engagements

11. In an audit of the financial statements of a company with operations in multiple locations or business units,[13/] the auditor should determine the extent to which audit procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual locations or business units. The auditor should assess the risks of material

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[10/] See, e.g., paragraph .06 of AU sec. 230, *Due Professional Care in the Performance of Work,* paragraph 16 of this standard, and paragraph 5.a. of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

[11/] Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

[12/] Auditing Standard No. 13 and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

[13/] The term "business units" includes subsidiaries, divisions, branches, components, or investments.

misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit.

12. Factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures include:

a. The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including, e.g., significant transactions executed at the location or business unit that are outside the normal course of business for the company, or that otherwise appear to be unusual given the auditor's understanding of the company and its environment;[14/]

b. The materiality of the location or business unit;[15/]

c. The specific risks associated with the location or business unit that present a reasonable possibility[16/] of material misstatement to the company's consolidated financial statements;

d. Whether the risks of material misstatement associated with the location or business unit apply to other locations or business units such that, in combination, they present a reasonable possibility of material misstatement to the company's consolidated financial statements;

e. The degree of centralization of records or information processing;

[14/] Paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*

[15/] Paragraph 10 of Auditing Standard No. 11 describes the consideration of materiality in planning and performing audit procedures at an individual location or business unit.

[16/] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

f. The effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or business unit; and

g. The frequency, timing, and scope of monitoring activities by the company or others at the location or business unit.

> Note: When performing an audit of internal control over financial reporting, refer to Appendix B, Special Topics, of Auditing Standard No. 5 [17] for considerations when a company has multiple locations or business units.

13. In determining the locations or business units at which to perform audit procedures, the auditor may take into account relevant activities performed by internal audit, as described in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* or others, as described in Auditing Standard No. 5. AU sec. 322 and Auditing Standard No. 5 establish requirements regarding using the work of internal audit and others, respectively.

14. AU sec. 543, *Part of Audit Performed by Other Independent Auditors,* describes the auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or more of the locations or business units that are included in the consolidated financial statements.[18] In those situations, the auditor should perform the procedures in paragraphs 11-13 of this standard to determine the locations or business units at which audit procedures should be performed.

Changes During the Course of the Audit

15. The auditor should modify the overall audit strategy and the audit plan as necessary if circumstances change significantly during the course of the audit, including changes due to a revised assessment of the risks of material misstatement or the discovery of a previously unidentified risk of material misstatement.

17/ Paragraphs B10-B16 of Auditing Standard No. 5.

18/ For integrated audits, see also paragraphs C8-C11 of Auditing Standard No. 5.

Persons with Specialized Skill or Knowledge

16. The auditor should determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

17. If a person with specialized skill or knowledge employed or engaged by the auditor participates in the audit, the auditor should have sufficient knowledge of the subject matter to be addressed by such a person to enable the auditor to:

a. Communicate the objectives of that person's work;

b. Determine whether that person's procedures meet the auditor's objectives; and

c. Evaluate the results of that person's procedures as they relate to the nature, timing, and extent of other planned audit procedures and the effects on the auditor's report.

Additional Considerations in Initial Audits

18. The auditor should undertake the following activities before starting an initial audit:

a. Perform procedures regarding the acceptance of the client relationship and the specific audit engagement; and

b. Communicate with the predecessor auditor in situations in which there has been a change of auditors in accordance with AU sec. 315, *Communications Between Predecessor and Successor Auditors.*

19. The purpose and objective of planning the audit are the same for an initial audit or a recurring audit engagement. However, for an initial audit, the auditor should determine the additional planning activities necessary to establish an appropriate audit strategy and audit plan, including determining the audit procedures necessary to obtain sufficient appropriate audit evidence regarding the opening balances.[19/]

[19/] See also paragraph 3 of Auditing Standard No. 6, *Evaluating Consistency of Financial Statements.*

APPENDIX A − Definition

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Engagement partner – The member of the engagement team with primary responsibility for the audit.

APPENDIX 3

Auditing Standard No. 10

Supervision of the Audit Engagement

Introduction

1. This standard establishes requirements regarding supervision of the audit engagement, including supervising the work of engagement team members.

Objective

2. The objective of the auditor is to supervise the audit engagement, including supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

Responsibility of the Engagement Partner for Supervision

3. The **engagement partner** [1/] is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for proper supervision of the work of engagement team members and for compliance with PCAOB standards, including standards regarding using the work of specialists,[2/] other auditors,[3/] internal auditors,[4/] and others who are involved in testing controls.[5/] Paragraphs 5-6 of this

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1/ Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

2/ AU sec. 336, *Using the Work of a Specialist.*

3/ AU sec. 543, *Part of Audit Performed by Other Independent Auditors.*

4/ AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.*

5/ Paragraphs 16-19 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

standard describe the nature and extent of supervisory activities necessary for proper supervision of engagement team members.[6/]

4. The engagement partner may seek assistance from appropriate engagement team members in fulfilling his or her responsibilities pursuant to this standard. Engagement team members who assist the engagement partner with supervision of the work of other engagement team members also should comply with the requirements in this standard with respect to the supervisory responsibilities assigned to them.

Supervision of Engagement Team Members

5. The engagement partner and, as applicable, other engagement team members performing supervisory activities, should:

a. Inform engagement team members of their responsibilities,[7/] including:

(1) The objectives of the procedures that they are to perform;

(2) The nature, timing, and extent of procedures they are to perform; and

(3) Matters that could affect the procedures to be performed or the evaluation of the results of those procedures, including relevant aspects of the company, its environment, and its internal control over financial reporting,[8/] and possible accounting and auditing issues;

b. Direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory

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6/ See also paragraph .06 of AU sec. 230, *Due Professional Care in the Performance of Work.*

7/ AU sec. 230.06 and paragraph 5 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement,* establish requirements regarding the appropriate assignment of engagement team members.

8/ Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* describes the auditor's responsibilities for obtaining an understanding of the company, its environment, and its internal control over financial reporting.

activities so they can evaluate those issues and determine that appropriate actions are taken in accordance with PCAOB standards;[9/]

> Note: In applying due professional care in accordance with AU sec. 230, each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or the auditor's report regardless of how those disagreements or concerns may have arisen.

c. Review the work of engagement team members to evaluate whether:

(1) The work was performed and documented;

(2) The objectives of the procedures were achieved; and

(3) The results of the work support the conclusions reached.[10/]

6. To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, the engagement partner and other engagement team members performing supervisory activities should take into account:

a. The nature of the company, including its size and complexity;[11/]

b. The nature of the assigned work for each engagement team member, including:

(1) The procedures to be performed, and

[9/] See, e.g., paragraph 15 of Auditing Standard No. 9, *Audit Planning,* paragraph 74 of Auditing Standard No. 12, and paragraphs 20-23 and 35-36 of Auditing Standard No. 14, *Evaluating Audit Results.*

[10/] Auditing Standard No. 14 describes the auditor's responsibilities for evaluating the results of the audit, and Auditing Standard No. 3, *Audit Documentation,* establishes requirements regarding audit documentation.

[11/] Paragraph 10 of Auditing Standard No. 12.

(2) The controls or accounts and disclosures to be tested;

c. The risks of material misstatement; and

d. The knowledge, skill, and ability of each engagement team member.[12/]

Note: In accordance with the requirements of paragraph 5 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, the extent of supervision of engagement team members should be commensurate with the risks of material misstatement. [13/]

[12/] See also paragraph 5.a. of Auditing Standard No. 13 and AU sec. 230.06.

[13/] Paragraph 5.b. of Auditing Standard No. 13 indicates that the extent of supervision of engagement team members is part of the auditor's overall responses to the risks of material misstatement.

APPENDIX A − Definition

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Engagement partner – The member of the engagement team with primary responsibility for the audit.

APPENDIX 4

Auditing Standard No. 11

Consideration of Materiality in Planning and Performing an Audit

Introduction

1. This standard establishes requirements regarding the auditor's consideration of materiality in planning and performing an audit.[1/]

Materiality in the Context of an Audit

2. In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[2/] As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him …."[3/]

3. To obtain reasonable assurance about whether the financial statements are free of material misstatement, the auditor should plan and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements. This includes being alert while planning and performing audit procedures for misstatements that could be material due to quantitative or qualitative factors. Also, the evaluation of uncorrected misstatements in accordance with Auditing Standard No. 14, *Evaluating Audit Results,* requires consideration of both qualitative and quantitative factors.[4/] However, it

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[1/] Auditing Standard No. 14 establishes requirements regarding the auditor's consideration of materiality in evaluating audit results.

[2/] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

[3/] TSC Industries, 426 U.S. at 450.

[4/] Appendix B of Auditing Standard No. 14.

ordinarily is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors.

4. For integrated audits, Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, states, "In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements."[5/]

Objective

5. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing audit procedures.

Considering Materiality in Planning and Performing an Audit

Establishing a Materiality Level for the Financial Statements as a Whole

6. To plan the nature, timing, and extent of audit procedures, the auditor should establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This includes consideration of the company's earnings and other relevant factors. To determine the nature, timing, and extent of audit procedures, the materiality level for the financial statements as a whole needs to be expressed as a specified amount.

> Note: If financial statements for the audit period are not available, the auditor may establish an initial materiality level based on estimated or preliminary financial statement amounts. In those situations, the auditor should take into account the effects of known or expected changes in the company's financial statements, including significant transactions or adjustments that are expected to be reflected in the financial statements at the end of the period.

Establishing Materiality Levels for Particular Accounts or Disclosures

7. The auditor should evaluate whether, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial

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[5/] Paragraph 20 of Auditing Standard No. 5.

statements as a whole would influence the judgment of a reasonable investor. If so, the auditor should establish separate materiality levels for those accounts or disclosures to plan the nature, timing, and extent of audit procedures for those accounts or disclosures.

> Note: Lesser amounts of misstatements could influence the judgment of a reasonable investor because of qualitative factors, e.g., because of the sensitivity of circumstances surrounding misstatements, such as conflicts of interest in related party transactions.

Determining Tolerable Misstatement

8. The auditor should determine the amount or amounts of tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level. The auditor should determine tolerable misstatement at an amount or amounts that reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the financial statements. Accordingly, tolerable misstatement should be less than the materiality level for the financial statements as a whole and, if applicable, the materiality level or levels for particular accounts or disclosures.

9. In determining tolerable misstatement and planning and performing audit procedures, the auditor should take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods.

Considerations for Multi-location Engagements

10. For purposes of the audit of the consolidated financial statements of a company with multiple locations or business units, the auditor should determine tolerable misstatement for the individual locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements. Accordingly, tolerable misstatement at an individual location should be less than the materiality level for the financial statements as a whole.

Considerations as the Audit Progresses

11. The auditor should reevaluate the established materiality level or levels and tolerable misstatement when, because of changes in the particular circumstances or additional information that comes to the auditor's attention, there is a substantial

likelihood that misstatements of amounts that differ significantly from the materiality level or levels that were established initially would influence the judgment of a reasonable investor. Situations in which changes in circumstances or additional information that comes to the auditor's attention would require such reevaluation include:

a. The materiality level or levels and tolerable misstatement were established initially based on estimated or preliminary financial statement amounts that differ significantly from actual amounts.

b. Events or changes in conditions occurring after the materiality level or levels and tolerable misstatement were established initially are likely to affect investors' perceptions about the company's financial position, results of operations, or cash flows.

> Note: Examples of such events or changes in conditions include (1) changes in laws, regulations, or the applicable financial reporting framework that affect investors' expectations about the measurement or disclosure of certain items and (2) significant new contractual arrangements that draw attention to a particular aspect of a company's business that is separately disclosed in the financial statements.

12. If the auditor's reevaluation results in a lower amount for the materiality level or levels or tolerable misstatement than initially established by the auditor, the auditor should (1) evaluate the effect, if any, of the lower amount or amounts on his or her risk assessments and audit procedures and (2) modify the nature, timing, and extent of audit procedures as necessary to obtain sufficient appropriate audit evidence.

> Note: The reevaluation of the materiality level or levels and tolerable misstatement is also relevant to the auditor's evaluation of uncorrected misstatements in accordance with Auditing Standard No. 14.[6/]

[6/] Paragraph 17 of Auditing Standard No. 14.

APPENDIX 5

Auditing Standard No. 12

Identifying and Assessing Risks of Material Misstatement

Introduction

1. This standard establishes requirements regarding the process of identifying and assessing risks of material misstatement[1/] of the financial statements.

2. Paragraphs 4-58 of this standard discuss the auditor's responsibilities for performing **risk assessment procedures**.[2/] Paragraphs 59-73 of this standard discuss identifying and assessing the risks of material misstatement using information obtained from performing risk assessment procedures.

Objective

3. The objective of the auditor is to identify and appropriately assess the risks of material misstatement, thereby providing a basis for designing and implementing responses to the risks of material misstatement.

Performing Risk Assessment Procedures

4. The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud,[3/] and designing further audit procedures.[4/]

[1/] Paragraphs 5-8 of Auditing Standard No. 8, *Audit Risk*.

[2/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

[3/] AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, discusses fraud, its characteristics, and the types of misstatements due to fraud that are relevant to the audit, i.e., misstatements arising from fraudulent financial reporting and misstatements arising from asset misappropriation.

[4/] Auditing Standard No. 15, *Audit Evidence*, describes further audit procedures as consisting of tests of controls and substantive procedures.

5. Risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. For example, external or company-specific factors can affect the judgments involved in determining accounting estimates or create pressures to manipulate the financial statements to achieve certain financial targets. Also, risks of material misstatement may relate to, e.g., personnel who lack the necessary financial reporting competencies, information systems that fail to accurately capture business transactions, or financial reporting processes that are not adequately aligned with the requirements in the applicable financial reporting framework. Thus, the audit procedures that are necessary to identify and appropriately assess the risks of material misstatement include consideration of both external factors and company-specific factors. This standard discusses the following risk assessment procedures:

a. Obtaining an understanding of the company and its environment (paragraphs 7-17);

b. Obtaining an understanding of internal control over financial reporting (paragraphs 18-40);

c. Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company (paragraphs 41-45);

d. Performing analytical procedures (paragraphs 46-48);

e. Conducting a discussion among engagement team members regarding the risks of material misstatement (paragraphs 49-53); and

f. Inquiring of the audit committee, management, and others within the company about the risks of material misstatement (paragraphs 54-58).

> Note: This standard describes an approach to identifying and assessing risks of material misstatement that begins at the financial statement level and with the auditor's overall understanding of the company and its environment and works down to the significant accounts and disclosures and their relevant assertions.[5/]

[5/] Paragraph 11 of Auditing Standard No. 15 discusses financial statement assertions.

6. In an integrated audit, the risks of material misstatement of the financial statements are the same for both the audit of internal control over financial reporting and the audit of financial statements. The auditor's risk assessment procedures should apply to both the audit of internal control over financial reporting and the audit of financial statements.

Obtaining an Understanding of the Company and Its Environment

7. The auditor should obtain an understanding of the company and its environment ("understanding of the company") to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. Obtaining an understanding of the company includes understanding:

a. Relevant industry, regulatory, and other external factors;

b. The nature of the company;

c. The company's selection and application of accounting principles, including related disclosures;

d. The **company's objectives and strategies** and those related **business risks** that might reasonably be expected to result in risks of material misstatement; and

e. The company's measurement and analysis of its financial performance.

8. In obtaining an understanding of the company, the auditor should evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.

Industry, Regulatory, and Other External Factors

9. Obtaining an understanding of relevant industry, regulatory, and other external factors encompasses industry factors, including the competitive environment and technological developments; the regulatory environment, including the applicable

financial reporting framework[6/] and the legal and political environment;[7/] and external factors, including general economic conditions.

Nature of the Company

10. Obtaining an understanding of the nature of the company includes understanding:

- The company's organizational structure and management personnel;
- The sources of funding of the company's operations and investment activities, including the company's capital structure, noncapital funding (e.g., subordinated debt or dependencies on supplier financing), and other debt instruments;
- The company's significant investments, including equity method investments, joint ventures, and variable interest entities;
- The company's operating characteristics, including its size and complexity;

  Note: The size and complexity of a company might affect the risks of misstatement and how the company addresses those risks.
- The sources of the company's earnings, including the relative profitability of key products and services; and
- Key supplier and customer relationships.

  Note: The auditor should take into account the information gathered while obtaining an understanding of the nature of the company when determining the existence of related parties in accordance with AU sec. 334, *Related Parties.*

[6/] The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

[7/] AU sec. 317, *Illegal Acts by Clients*, discusses the auditor's consideration of laws and regulations relevant to the audit.

11. As part of obtaining an understanding of the company as required by paragraph 7, the auditor should consider performing the following procedures and the extent to which the procedures should be performed:

- Reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and, in an integrated audit, the effectiveness of the company's internal control over financial reporting, e.g., company-issued press releases, company-prepared presentation materials for analysts or investor groups, and analyst reports;

- Observing or reading transcripts of earnings calls and, to the extent publicly available, other meetings with investors or rating agencies;

- Obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses; and

- Obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders to identify potentially significant unusual developments (e.g., from Forms 3, 4, 5, 13D, and 13G).

Selection and Application of Accounting Principles, Including Related Disclosures

12. As part of obtaining an understanding of the company's selection and application of accounting principles, including related disclosures, the auditor should evaluate whether the company's selection and application of accounting principles are appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the relevant industry. Also, to identify and assess risks of material misstatement related to omitted, incomplete, or inaccurate disclosures, the auditor should develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.

13. The following matters, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles, including related disclosures:

- Significant changes in the company's accounting principles, financial reporting policies, or disclosures and the reasons for such changes;
- The financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles;
- The accounts or disclosures for which judgment is used in the application of significant accounting principles, especially in determining management's estimates and assumptions;
- The effect of significant accounting principles in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;
- The methods the company uses to account for significant and unusual transactions; and
- Financial reporting standards and laws and regulations that are new to the company, including when and how the company will adopt such requirements.

Company Objectives, Strategies, and Related Business Risks

14. The purpose of obtaining an understanding of the company's objectives, strategies, and related business risks is to identify business risks that could reasonably be expected to result in material misstatement of the financial statements.

> Note: Some relevant business risks might be identified through other risk assessment procedures, such as obtaining an understanding of the nature of the company and understanding industry, regulatory, and other external factors.

15. The following are examples of situations in which business risks might result in material misstatement of the financial statements:

- Industry developments (a potential related business risk might be, e.g., that the company does not have the personnel or expertise to deal with the changes in the industry.)
- New products and services (a potential related business risk might be, e.g., that the new product or service will not be successful.)

- Use of information technology ("IT") (a potential related business risk might be, e.g., that systems and processes are incompatible.)

- New accounting requirements (a potential related business risk might be, e.g., incomplete or improper implementation of a new accounting requirement.)

- Expansion of the business (a potential related business risk might be, e.g., that the demand for the company's products or services has not been accurately estimated.)

- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, e.g., incomplete or improper implementation of the strategy.)

- Current and prospective financing requirements (a potential related business risk might be, e.g., the loss of financing due to the company's inability to meet financing requirements.)

- Regulatory requirements (a potential related business risk might be, e.g., that there is increased legal exposure.)

Note: Business risks could affect risks of material misstatement at the financial statement level, which would affect many accounts and disclosures in the financial statements. For example, a company's loss of financing or declining conditions affecting the company's industry could affect its ability to settle its obligations when due. This, in turn, could affect the risks of material misstatement related to, e.g., the classification of long-term liabilities or valuation of long-term assets, or it could result in substantial doubt about the company's ability to continue as a going concern. Other business risks could affect the risks of material misstatement for particular accounts, disclosures, or assertions. For example, an unsuccessful new product or service or failed business expansion might affect the risks of material misstatement related to the valuation of inventory and other related assets.

Company Performance Measures

16. The purpose of obtaining an understanding of the company's performance measures is to identify performance measures, whether external or internal, that affect the risks of material misstatement.

17. The following are examples of performance measures that might affect the risks of material misstatement:

- Measures that form the basis for contractual commitments or incentive compensation arrangements;
- Measures used by external parties, such as analysts and rating agencies, to review the company's performance; and
- Measures the company uses to monitor its operations that highlight unexpected results or trends that prompt management to investigate their cause and take corrective action, including correction of misstatements.

Note: The first two examples represent performance measures that can affect the risks of material misstatement by creating incentives or pressures for management of the company to manipulate certain accounts or disclosures to achieve certain performance targets (or conceal a failure to achieve those targets). The third example represents performance measures that management might use to monitor risks affecting the financial statements.

Note: Smaller companies might have less formal processes to measure and review financial performance. In such cases, the auditor might identify relevant performance measures by considering the information that the company uses to manage the business.

Obtaining an Understanding of Internal Control Over Financial Reporting

18. The auditor should obtain a sufficient understanding of each component[8/] of internal control over financial reporting ("understanding of internal control") to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.

19. The nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company;[9/] the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting.

> Note: The auditor also might obtain an understanding of certain controls that are not part of internal control over financial reporting, e.g., controls over the completeness and accuracy of operating or other nonfinancial information used as audit evidence.[10/]

20. Obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.

> Note: Procedures the auditor performs to obtain evidence about design effectiveness include inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation.

[8/] Paragraphs 21-22 of this standard discuss components of internal control over financial reporting.

[9/] Paragraph 13 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, states, "The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its control objectives. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks."

[10/] Paragraph 10 of Auditing Standard No. 15.

Walkthroughs, as described in paragraphs 37-38, that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Note: Determining whether a control has been implemented means determining whether the control exists and whether the company is using it. The procedures to determine whether a control has been implemented may be performed in connection with the evaluation of its design. Procedures performed to determine whether a control has been implemented include inquiry of appropriate personnel, in combination with observation of the application of controls or inspection of documentation. Walkthroughs, as described in paragraphs 37-38, that include these procedures ordinarily are sufficient to determine whether a control has been implemented.

21. Internal control over financial reporting can be described as consisting of the following components:[11/]

- The control environment,
- The company's risk assessment process,
- Information and communication,
- Control activities, and
- Monitoring of controls.

22. Management might use an internal control framework with components that differ from the components identified in the preceding paragraph when establishing and maintaining the company's internal control over financial reporting. In evaluating the design of controls and determining whether they have been implemented in an audit of financial statements only, the auditor may use the framework used by management or another suitable, recognized framework.[12/] For integrated audits, Auditing Standard No. 5, states, "The auditor should use the same suitable, recognized control framework to

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[11/] Different internal control frameworks use different terms and approaches to describe the components of internal control over financial reporting.

[12/] See Securities Exchange Act Release No. 34-47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting."[13/] If the auditor uses a suitable, recognized internal control framework with components that differ from those listed in the preceding paragraph, the auditor should adapt the requirements in paragraphs 23-36 of this standard to conform to the components in the framework used.

Control Environment

23. The auditor should obtain an understanding of the company's control environment, including the policies and actions of management, the board, and the audit committee concerning the company's control environment.

24. Obtaining an understanding of the control environment includes assessing:

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

  Note: In an audit of financial statements only, this assessment may be based on the evidence obtained in understanding the control environment, in accordance with paragraph 23, and the other relevant knowledge possessed by the auditor. In an integrated audit of financial statements and internal control over financial reporting, Auditing Standard No. 5[14/] describes the auditor's responsibility for evaluating the control environment.

25. If the auditor identifies a control deficiency[15/] in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor, as discussed in paragraphs 65-66 of this standard.

13/ Paragraph 5 of Auditing Standard No. 5.

14/ Paragraph 25 of Auditing Standard No. 5.

15/ Paragraph A3 of Auditing Standard No. 5.

The Company's Risk Assessment Process

26. The auditor should obtain an understanding of management's process for:

a. Identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud ("fraud risks");

b. Assessing the likelihood and significance of misstatements resulting from those risks; and

c. Deciding about actions to address those risks.

27. Obtaining an understanding of the company's risk assessment process includes obtaining an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.

Information and Communication

28. *Information System Relevant to Financial Reporting.* The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including:

a. The classes of transactions in the company's operations that are significant to the financial statements;

b. The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported;

c. The related accounting records, supporting information, and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions;

d. How the information system captures events and conditions, other than transactions,[16/] that are significant to the financial statements; and

e. The period-end financial reporting process.

[16/] Examples of such events and conditions include depreciation and amortization and conditions affecting the recoverability of assets.

Note: Appendix B discusses additional considerations regarding manual and automated systems and controls.

29. The auditor also should obtain an understanding of how IT affects the company's flow of transactions. (See Appendix B.)

Note: The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the approach used to identify significant accounts and disclosures and their relevant assertions and, when applicable, to select the controls to test, as well as to assess risk and allocate audit effort.

30. A company's business processes are the activities designed to:

a. Develop, purchase, produce, sell and distribute a company's products or services;

b. Record information, including accounting and financial reporting information; and

c. Ensure compliance with laws and regulations relevant to the financial statements.

31. Obtaining an understanding of the company's business processes assists the auditor in obtaining an understanding of how transactions are initiated, authorized, processed, and recorded.

32. A company's period-end financial reporting process, as referred to in paragraph 28.e., includes the following:

- Procedures used to enter transaction totals into the general ledger;
- Procedures related to the selection and application of accounting principles;[17/]
- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;

[17/] Paragraphs 12-13 of this standard.

- Procedures used to record recurring and nonrecurring adjustments to the annual financial statements (and quarterly financial statements, if applicable); and

- Procedures for preparing annual financial statements and related disclosures (and quarterly financial statements, if applicable).

33. *Communication.* The auditor should obtain an understanding of how the company communicates financial reporting roles and responsibilities and significant matters relating to financial reporting to relevant company personnel and others, including:

- Communications between management, the audit committee, and the board of directors; and

- Communications to external parties, including regulatory authorities and shareholders.

Control Activities

34. The auditor should obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures, as described in paragraph 18 of this standard.[18/] As the auditor obtains an understanding of the other components of internal control over financial reporting, he or she is also likely to obtain knowledge about some control activities. The auditor should use his or her knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control over financial reporting in determining the extent to which it is necessary to devote additional attention to obtaining an understanding of control activities to assess the factors that affect the risks of material misstatement and to design further audit procedures.

> Note: A broader understanding of control activities is needed for relevant assertions for which the auditor plans to rely on controls. Also, in the audit of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit.

18/ Also see paragraph B5 of Appendix B of this standard.

Monitoring of Controls

35. The auditor should obtain an understanding of the major types of activities that the company uses to monitor the effectiveness of its internal control over financial reporting and how the company initiates corrective actions related to its controls.[19/]

36. An understanding of the company's monitoring activities includes understanding the source of the information used in the monitoring activities.

Performing Walkthroughs

37. As discussed in paragraph 20, the auditor may perform walkthroughs as part of obtaining an understanding of internal control over financial reporting. For example, the auditor may perform walkthroughs in connection with understanding the flow of transactions in the information system relevant to financial reporting, evaluating the design of controls relevant to the audit, and determining whether those controls have been implemented. In performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and IT that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

> Note: For integrated audits, Auditing Standard No. 5 establishes certain objectives that the auditor should achieve to further understand likely sources of potential misstatements and as part of selecting the controls to test. Auditing Standard No. 5 states that performing walkthroughs will frequently be the most effective way of achieving those objectives.[20/]

38. In performing a walkthrough, at the points at which important processing procedures occur, the auditor questions the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions, combined with the other walkthrough procedures,

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[19/] In some companies, internal auditors or others performing an equivalent function contribute to the monitoring of controls. AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* establishes requirements regarding the auditor's consideration and use of the work of the internal audit function.

[20/] See paragraphs 34-38 of Auditing Standard No. 5.

allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the auditor to gain an understanding of the different types of significant transactions handled by the process.

Relationship of Understanding of Internal Control to Tests of Controls

39. The objective of obtaining an understanding of internal control, as discussed in paragraph 18 of this standard, is different from testing controls for the purpose of assessing control risk[21/] or for the purpose of expressing an opinion on internal control over financial reporting in the audit of internal control over financial reporting.[22/] The auditor may obtain an understanding of internal control concurrently with performing tests of controls if he or she obtains sufficient appropriate evidence to achieve the objectives of both procedures. Also, the auditor should take into account the evidence obtained from understanding internal control when assessing control risk and, in the audit of internal control over financial reporting, forming an opinion about the effectiveness of internal control over financial reporting.

40. *Relationship of Understanding of Internal Control to Evaluating Entity-Level Controls in an Audit of Internal Control Over Financial Reporting.* Auditing Standard No. 5 states, "The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting."[23/] The procedures performed to obtain an understanding of certain components of internal control in accordance with this standard, e.g., the control environment, the company's risk assessment process, information and communication, and monitoring of controls, might provide evidence that is relevant to the auditor's evaluation of entity-level controls.[24/] The auditor should take into account the evidence

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[21/] Paragraphs 16-35 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

[22/] Paragraph B1 of Auditing Standard No. 5.

[23/] Paragraph 22 of Auditing Standard No. 5.

[24/] The entity-level controls included in paragraph 24 of Auditing Standard No. 5 include controls related to the control environment; the company's risk assessment process; centralized processing and controls; controls over the period-end financial reporting process; and controls to monitor other controls.

obtained from understanding internal control when determining the nature, timing, and extent of procedures necessary to support the auditor's conclusions about the effectiveness of entity-level controls in the audit of internal control over financial reporting.

Considering Information from the Client Acceptance and Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements

41. *Client Acceptance and Retention and Audit Planning Activities.* The auditor should evaluate whether information obtained from the client acceptance and retention evaluation process or audit planning activities is relevant to identifying risks of material misstatement. Risks of material misstatement identified during those activities should be assessed as discussed beginning in paragraph 59 of this standard.

42. *Past Audits.* In subsequent years, the auditor should incorporate knowledge obtained during past audits into the auditor's process for identifying risks of material misstatement, including when identifying significant ongoing matters that affect the risks of material misstatement or determining how changes in the company or its environment affect the risks of material misstatement, as discussed in paragraph 8 of this standard.

43. If the auditor plans to limit the nature, timing, or extent of his or her risk assessment procedures by relying on information from past audits, the auditor should evaluate whether the prior years' information remains relevant and reliable.

44. *Other Engagements.* When the auditor has performed a review of interim financial information in accordance with AU sec. 722, *Interim Financial Information,* the auditor should evaluate whether information obtained during the review is relevant to identifying risks of material misstatement in the year-end audit.

45. The auditor should obtain an understanding of the nature of the services that have been performed for the company by the auditor or affiliates of the firm[25/] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement.[26/]

[25/] See PCAOB Rule 3501(a)(i), which defines "affiliate of the accounting firm."

[26/] Paragraph 7 of Auditing Standard No. 9, *Audit Planning.*

Performing Analytical Procedures

46. The auditor should perform analytical procedures that are designed to:

   a. Enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior year end; and

   b. Identify areas that might represent specific risks relevant to the audit, including the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.

47. In applying analytical procedures as risk assessment procedures, the auditor should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud. Also, when the auditor has performed a review of interim financial information in accordance with AU sec. 722, he or she should take into account the analytical procedures applied in that review when designing and applying analytical procedures as risk assessment procedures.

48. When performing an analytical procedure, the auditor should use his or her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure.[27/] When comparison of those expectations with relationships derived from recorded amounts yields unusual or unexpected results, the auditor should take into account those results in identifying the risks of material misstatement.

> Note: Analytical procedures performed as risk assessment procedures often use data that is preliminary or data that is aggregated at a high level, and, in those instances, such analytical procedures are not designed with the level of precision necessary for substantive analytical procedures.

[27/] Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

Conducting a Discussion among Engagement Team Members Regarding Risks of Material Misstatement

49. The key engagement team members should discuss (1) the company's selection and application of accounting principles, including related disclosure requirements, and (2) the susceptibility of the company's financial statements to material misstatement due to error or fraud.

> Note: The key engagement team members should discuss the potential for material misstatement due to fraud either as part of the discussion regarding risks of material misstatement or in a separate discussion.[28/]

> Note: As discussed in paragraph 67, the financial statements might be susceptible to misstatement through omission of required disclosures or presentation of inaccurate or incomplete disclosures.

50. Key engagement team members include all engagement team members who have significant engagement responsibilities, including the engagement partner. The manner in which the discussion is conducted depends on the individuals involved and the circumstances of the engagement. For example, if the audit involves more than one location, there could be multiple discussions with team members in differing locations. The engagement partner or other key engagement team members should communicate the important matters from the discussion to engagement team members who are not involved in the discussion.

> Note: If the audit is performed entirely by the engagement partner, that engagement partner, having personally conducted the planning of the audit, is responsible for evaluating the susceptibility of the company's financial statements to material misstatement.

51. Communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change.[29/]

[28/] Paragraphs 52-53 of this standard.

[29/] See also paragraph 29 of Auditing Standard No. 14, *Evaluating Audit Results*.

Discussion of the Potential for Material Misstatement Due to Fraud

52. The discussion among the key engagement team members about the potential for material misstatement due to fraud should occur with an attitude that includes a questioning mind, and the key engagement team members should set aside any prior beliefs they might have that management is honest and has integrity. The discussion among the key engagement team members should include:

- An exchange of ideas, or "brainstorming," among the key engagement team members, including the engagement partner, about how and where they believe the company's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the company could be misappropriated, including (a) the susceptibility of the financial statements to material misstatement through related party transactions and (b) how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures;

- A consideration of the known external and internal factors affecting the company that might (a) create incentives or pressures for management and others to commit fraud, (b) provide the opportunity for fraud to be perpetrated, and (c) indicate a culture or environment that enables management to rationalize committing fraud;

- A consideration of the risk of management override; and

- A consideration of the potential audit responses to the susceptibility of the company's financial statements to material misstatement due to fraud.

53. The auditor should emphasize the following matters to all engagement team members:

- The need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, as described in AU sec. 316;[30/]

[30/] AU sec. 316.13.

- The need to be alert for information or other conditions (such as those matters presented in Appendix C of Auditing Standard No. 14) that might affect the assessment of fraud risks; and

- If information or other conditions indicate that a material misstatement due to fraud might have occurred, the need to probe the issues, acquire additional evidence as necessary, and consult with other team members and, if appropriate, others in the firm including specialists.[31/]

Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

54. The auditor should inquire of the audit committee, or equivalent (or its chair), management, the internal audit function, and others within the company who might reasonably be expected to have information that is important to the identification and assessment of risks of material misstatement.

Note: The auditor's inquiries about risks of material misstatement should include inquiries regarding fraud risks.

55. The auditor should use his or her knowledge of the company and its environment, as well as information from other risk assessment procedures, to determine the nature of the inquiries about risks of material misstatement.

Inquiries Regarding Fraud Risks

56. The auditor's inquiries regarding fraud risks should include the following:

a. Inquiries of management regarding:

(1) Whether management has knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

(2) Management's process for identifying and responding to fraud risks in the company, including any specific fraud risks the company has identified or account balances or disclosures for which a fraud risk

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[31/] Paragraphs 20-23 of Auditing Standard No. 14 establish further requirements for evaluating whether misstatements might be indicative of fraud and determining the necessary procedures to be performed in those situations.

is likely to exist, and the nature, extent, and frequency of management's fraud risk assessment process;

(3) Controls that the company has established to address fraud risks the company has identified, or that otherwise help to prevent and detect fraud, including how management monitors those controls;

(4) For a company with multiple locations (a) the nature and extent of monitoring of operating locations or business segments and (b) whether there are particular operating locations or business segments for which a fraud risk might be more likely to exist;

(5) Whether and how management communicates to employees its views on business practices and ethical behavior;

(6) Whether management has received tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, management's responses to such tips and complaints; and

(7) Whether management has reported to the audit committee on how the company's internal control serves to prevent and detect material misstatements due to fraud.

b. Inquiries of the audit committee, or equivalent, or its chair regarding:

(1) The audit committee's views about fraud risks in the company;

(2) Whether the audit committee has knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

(3) Whether the audit committee is aware of tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, the audit committee's responses to such tips and complaints; and

(4) How the audit committee exercises oversight of the company's assessment of fraud risks and the establishment of controls to address fraud risks.

c. If the company has an internal audit function, inquiries of appropriate internal audit personnel regarding:

(1) The internal auditors' views about fraud risks in the company;

(2) Whether the internal auditors have knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

(3) Whether internal auditors have performed procedures to identify or detect fraud during the year, and whether management has satisfactorily responded to the findings resulting from those procedures; and

(4) Whether internal auditors are aware of instances of management override of controls and the nature and circumstances of such overrides.

57. In addition to the inquiries outlined in the preceding paragraph, the auditor should inquire of others within the company about their views regarding fraud risks, including, in particular, whether they have knowledge of fraud, alleged fraud, or suspected fraud. The auditor should identify other individuals within the company to whom inquiries should be directed and determine the extent of such inquiries by considering whether others in the company might have additional knowledge about fraud, alleged fraud, or suspected fraud or might be able to corroborate fraud risks identified in discussions with management or the audit committee. Examples of other individuals within the company to whom inquiries might be directed include:

- Employees with varying levels of authority within the company, including, e.g., company personnel with whom the auditor comes into contact during the course of the audit (a) in obtaining an understanding of internal control, (b) in observing inventory or performing cutoff procedures, or (c) in obtaining explanations for significant differences identified when performing analytical procedures;

- Operating personnel not directly involved in the financial reporting process;

- Employees involved in initiating, recording, or processing complex or unusual transactions, e.g., a sales transaction with multiple elements or a significant related party transaction; and

- In-house legal counsel.

58. When evaluating management's responses to inquiries about fraud risks and determining when it is necessary to corroborate management's responses, the auditor should take into account the fact that management is often in the best position to commit fraud. Also, the auditor should obtain evidence to address inconsistencies in responses to the inquiries.

Identifying and Assessing the Risks of Material Misstatement

59. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. In identifying and assessing risks of material misstatement, the auditor should:

a. Identify risks of misstatement using information obtained from performing risk assessment procedures (as discussed in paragraphs 4-58) and considering the characteristics of the accounts and disclosures in the financial statements.

> Note: Factors relevant to identifying fraud risks are discussed in paragraphs 65-69 of this standard.

b. Evaluate whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions.

c. Evaluate the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected.

> Note: In identifying and assessing risks at the assertion level, the auditor should evaluate how risks at the financial statement level could affect risks of misstatement at the assertion level.

d. Assess the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements.

Note: In assessing the likelihood and magnitude of potential misstatement, the auditor may take into account the planned degree of reliance on controls selected to test.[32/]

e. Identify significant accounts and disclosures[33/] and their relevant assertions[34/] (paragraphs 60-64 of this standard).

Note: The determination of whether an account or disclosure is significant or whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

f. Determine whether any of the identified and assessed risks of material misstatement are **significant risks** (paragraphs 70-71 of this standard).

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

60. To identify significant accounts and disclosures and their relevant assertions in accordance with paragraph 59.e., the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures.

32/ Paragraphs 16-35 of Auditing Standard No. 13.

33/ Paragraph A10 of Auditing Standard No. 5 states:

> An account or disclosure is a significant account or disclosure if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.

34/ Paragraph A9 of Auditing Standard No. 5 states:

> A relevant assertion is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include:

- Size and composition of the account;
- Susceptibility to misstatement due to error or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;
- Exposure to losses in the account;
- Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- Existence of related party transactions in the account; and
- Changes from the prior period in account and disclosure characteristics.

61. As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.

62. The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the audit of internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits.

> Note: In the financial statement audit, the auditor might perform substantive auditing procedures on financial statement accounts,

disclosures, and assertions that are not determined to be significant accounts and disclosures and relevant assertions.[35/]

63. The components of a potential significant account or disclosure might be subject to significantly differing risks.

64. When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements.

Factors Relevant to Identifying Fraud Risks

65. The auditor should evaluate whether the information gathered from the risk assessment procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks. Fraud risk factors are events or conditions that indicate (1) an incentive or pressure to perpetrate fraud, (2) an opportunity to carry out the fraud, or (3) an attitude or rationalization that justifies the fraudulent action. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances in which fraud exists. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are listed in AU sec. 316.85. These illustrative risk factors are classified based on the three conditions discussed in this paragraph, which generally are present when fraud exists.

> Note: The factors listed in AU sec. 316.85 cover a broad range of situations and are only examples. Accordingly, the auditor might identify additional or different fraud risk factors.

66. All three conditions discussed in the preceding paragraph are not required to be observed or evident to conclude that a fraud risk exists. The auditor might conclude that a fraud risk exists even when only one of these three conditions is present.

[35/] The auditor might perform substantive auditing procedures because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high or as a means of introducing unpredictability in the procedures performed. See paragraphs 11, 14, and 25 of Auditing Standard No. 14, for further discussion about undetected misstatement. See paragraph 61 of Auditing Standard No. 5 and paragraph 5.c. of Auditing Standard No. 13, for further discussion about the unpredictability of auditing procedures.

67. *Consideration of the Risk of Omitted, Incomplete, or Inaccurate Disclosures.* The auditor's evaluation of fraud risk factors in accordance with paragraph 65 should include evaluation of how fraud could be perpetrated or concealed by presenting incomplete or inaccurate disclosures or by omitting disclosures that are necessary for the financial statements to be presented fairly in conformity with the applicable financial reporting framework.

68. *Presumption of Fraud Risk Involving Improper Revenue Recognition.* The auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.

69. *Consideration of the Risk of Management Override of Controls.* The auditor's identification of fraud risks should include the risk of management override of controls.

> Note: Controls over management override are important to effective internal control over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override.

Factors Relevant to Identifying Significant Risks

70. To determine whether an identified and assessed risk is a significant risk, the auditor should evaluate whether the risk requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk.

> Note: The determination of whether a risk of material misstatement is a significant risk is based on inherent risk, without regard to the effect of controls.

71. Factors that should be evaluated in determining which risks are significant risks include:

a. The effect of the quantitative and qualitative risk factors discussed in paragraph 60 on the likelihood and potential magnitude of misstatements;

b. Whether the risk is a fraud risk;

Note: A fraud risk is a significant risk.

c. Whether the risk is related to recent significant economic, accounting, or other developments;

d. The complexity of transactions;

e. Whether the risk involves significant transactions with related parties;

f. The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

g. Whether the risk involves significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature.

Further Consideration of Controls

72. When the auditor has determined that a significant risk, including a fraud risk, exists, the auditor should evaluate the design of the company's controls that are intended to address fraud risks and other significant risks and determine whether those controls have been implemented, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18-40 of this standard.[36/]

73. Controls that address fraud risks include (a) specific controls designed to mitigate specific risks of fraud, e.g., controls to address risks of intentional misstatement of specific accounts and (b) controls designed to prevent, deter, and detect fraud, e.g., controls to promote a culture of honesty and ethical behavior.[37/] Such controls also include those that address the risk of management override of other controls.

[36/] Auditing Standard No. 13 discusses the auditor's response to fraud risks and other significant risks.

[37/] AU sec. 316.88 and paragraph 14 of Auditing Standard No. 5 present examples of controls that address fraud risks.

Revision of Risk Assessment

74. The auditor's assessment of the risks of material misstatement, including fraud risks, should continue throughout the audit. When the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.[38/]

[38/] See also paragraph 46 of Auditing Standard No. 13.

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Business risks – Risks that result from significant conditions, events, circumstances, actions, or inactions that could adversely affect a company's ability to achieve its objectives and execute its strategies. Business risks also might result from setting inappropriate objectives and strategies or from changes or complexity in the company's operations or management.

A3. Company's objectives and strategies – The overall plans for the company as established by management or the board of directors. Strategies are the approaches by which management intends to achieve its objectives.

A4. Risk assessment procedures – The procedures performed by the auditor to obtain information for identifying and assessing the risks of material misstatement in the financial statements whether due to error or fraud.

> Note: Risk assessment procedures by themselves do not provide sufficient appropriate evidence on which to base an audit opinion.

A5. Significant risk – A risk of material misstatement that requires special audit consideration.

APPENDIX B – Consideration of Manual and Automated Systems and Controls

B1. While obtaining an understanding of the company's information system related to financial reporting, the auditor should obtain an understanding of how the company uses information technology ("IT") and how IT affects the financial statements.[1/] The auditor also should obtain an understanding of the extent of manual controls and automated controls used by the company, including the IT general controls that are important to the effective operation of the automated controls. That information should be taken into account in assessing the risks of material misstatement.[2/]

B2. Controls in a manual system might include procedures such as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items.

B3. Alternatively, a company might use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format would replace paper documents. When IT is used to initiate, record, process, and report transactions, the IT systems and programs may include controls related to the relevant assertions of significant accounts and disclosures or may be critical to the effective functioning of manual controls that depend on IT.

B4. The auditor should obtain an understanding of specific risks to a company's internal control over financial reporting resulting from IT. Examples of such risks include:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both;

- Unauthorized access to data that might result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions or inaccurate recording of transactions (particular risks might arise when multiple users access a common database);

- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down

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[1/] See also AU sec. 324, *Service Organizations,* if the company uses a service organization for services that are part of the company's internal control over financial reporting.

[2/] See also paragraphs 16-17 of Auditing Standard No. 9, *Audit Planning*.

segregation of duties;

- Unauthorized changes to data in master files;
- Unauthorized changes to systems or programs;
- Failure to make necessary changes to systems or programs;
- Inappropriate manual intervention; and
- Potential loss of data or inability to access data as required.

B5. In obtaining an understanding of the company's control activities, the auditor should obtain an understanding of how the company has responded to risks arising from IT.

B6. When a company uses manual elements in internal control systems and the auditor plans to rely on, and therefore test, those manual controls, the auditor should design procedures to test the consistency in the application of those manual controls.

APPENDIX 6

Auditing Standard No. 13

The Auditor's Responses to the Risks of Material Misstatement

Introduction

1. This standard establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement.

Objective

2. The objective of the auditor is to address the risks of material misstatement through appropriate overall audit responses and audit procedures.

Responding to the Risks of Material Misstatement

3. To meet the objective in the preceding paragraph, the auditor must design and implement audit responses that address the risks of material misstatement that are identified and assessed in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

4. This standard discusses the following types of audit responses:

   a. Responses that have an overall effect on how the audit is conducted ("overall responses"), as described in paragraphs 5-7; and

   b. Responses involving the nature, timing, and extent of the audit procedures to be performed, as described in paragraphs 8-46.

Overall Responses

5. The auditor should design and implement overall responses to address the assessed risks of material misstatement as follows:

   a. *Making appropriate assignments of significant engagement responsibilities.* The knowledge, skill, and ability of engagement team members with significant engagement responsibilities should be commensurate with the assessed risks of material misstatement.[1/]

b. *Providing the extent of supervision that is appropriate for the circumstances, including, in particular, the assessed risks of material misstatement.* (See paragraphs 5–6 of Auditing Standard No. 10, *Supervision of the Audit Engagement*.)

c. *Incorporating elements of unpredictability in the selection of audit procedures to be performed.* As part of the auditor's response to the assessed risks of material misstatement, including the assessed risks of material misstatement due to fraud ("fraud risks"), the auditor should incorporate an element of unpredictability in the selection of auditing procedures to be performed from year to year. Examples of ways to incorporate an element of unpredictability include:

(1) Performing audit procedures related to accounts, disclosures, and assertions that would not otherwise be tested based on their amount or the auditor's assessment of risk;

(2) Varying the timing of the audit procedures;

(3) Selecting items for testing that have lower amounts or are otherwise outside customary selection parameters;

(4) Performing audit procedures on an unannounced basis; and

(5) In multi-location audits, varying the location or the nature, timing, and extent of audit procedures at related locations or business units from year to year.[2/]

[1/] See also paragraph .06 of AU sec. 230, *Due Professional Care in the Performance of Work.*

[2/] For integrated audits, paragraphs 61 and B13 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, establish requirements for introducing unpredictability in testing of controls from year to year and in multi-location audits.

d. *Evaluating the company's selection and application of significant accounting principles.* The auditor should evaluate whether the company's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions,[3/] are indicative of bias that could lead to material misstatement of the financial statements.

> Note: Paragraph .11 of AU sec. 380, *Communication With Audit Committees,* discusses the auditor's judgments about the quality of a company's accounting principles.

6. The auditor also should determine whether it is necessary to make pervasive changes to the nature, timing, or extent of audit procedures to adequately address the assessed risks of material misstatement. Examples of such pervasive changes include modifying the audit strategy to:

a. Increase the substantive testing of the valuation of numerous significant accounts at year end because of significantly deteriorating market conditions, and

b. Obtain more persuasive audit evidence from substantive procedures due to the identification of pervasive weaknesses in the company's control environment.

7. Due professional care requires the auditor to exercise professional skepticism.[4/] Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence. The auditor's responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating

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[3/] Paragraphs 12-13 of Auditing Standard No. 12 discuss the auditor's responsibilities regarding obtaining an understanding of the company's selection and application of accounting principles. See also paragraphs .66-.67 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* and paragraphs .04 and .06 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.*

[4/] AU secs. 230.07-.09.

audit evidence.[5/] Examples of the application of professional skepticism in response to the assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or employed by the auditor, or examination of documentation from independent sources.

Responses Involving the Nature, Timing, and Extent of Audit Procedures

8. The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.

9. In designing the audit procedures to be performed, the auditor should:

a. Obtain more persuasive audit evidence the higher the auditor's assessment of risk;

b. Take into account the types of potential misstatements that could result from the identified risks and the likelihood and magnitude of potential misstatement;[6/]

c. In an integrated audit, design the testing of controls to accomplish the objectives of both audits simultaneously:

(1) To obtain sufficient evidence to support the auditor's control risk[7/] assessments for purposes of the audit of financial statements;[8/] and

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5/ AU sec. 316.13.

6/ For example, potential misstatements regarding disclosures include omission of required disclosures or presentation of inaccurate or incomplete disclosures.

7/ See paragraph 7.b. of Auditing Standard No. 8, *Audit Risk,* for a definition of control risk.

8/ For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

(2) To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end.

> Note: Auditing Standard No. 5 establishes requirements for tests of controls in the audit of internal control over financial reporting.

10. The audit procedures performed in response to the assessed risks of material misstatement can be classified into two categories: (1) tests of controls and (2) substantive procedures.[9/] Paragraphs 16-35 of this standard discuss tests of controls, and paragraphs 36-46 discuss substantive procedures.

> Note: Paragraphs 16-17 of this standard discuss when tests of controls are necessary in a financial statement audit. Ordinarily, tests of controls are performed for relevant assertions for which the auditor chooses to rely on controls to modify his or her substantive procedures.

Responses to Significant Risks

11. For significant risks, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed risks.

> Note: Auditing Standard No. 12 discusses identification of significant risks[10/] and states that fraud risks are significant risks.

Responses to Fraud Risks

12. The audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected.

9/ Substantive procedures consist of (a) tests of details of accounts and disclosures and (b) substantive analytical procedures.

10/ See paragraph 71 of Auditing Standard No. 12 for factors that the auditor should evaluate in determining which risks are significant risks.

Note: If the auditor identifies deficiencies in controls that are intended to address assessed fraud risks, the auditor should take into account those deficiencies when designing his or her response to those fraud risks.

Note: Auditing Standard No. 5 establishes requirements for addressing assessed fraud risks in the audit of internal control over financial reporting.[11/]

13. *Addressing Fraud Risks in the Audit of Financial Statements.* In the audit of financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks. If the auditor selects certain controls intended to address the assessed fraud risks for testing in accordance with paragraphs 16-17 of this standard, the auditor should perform tests of those controls.

14. The following are examples of ways in which planned audit procedures may be modified to address assessed fraud risks:

a. Changing the *nature* of audit procedures to obtain evidence that is more reliable or to obtain additional corroborative information;

b. Changing the *timing* of audit procedures to be closer to the end of the period or to the points during the period in which fraudulent transactions are more likely to occur; and

c. Changing the *extent* of the procedures applied to obtain more evidence, e.g., by increasing sample sizes or applying computer-assisted audit techniques to all of the items in an account.

Note: AU secs. 316.54-.67 provide additional examples of responses to assessed fraud risks relating to fraudulent financial reporting (e.g., revenue recognition, inventory quantities, and management estimates) and misappropriation of assets in the audit of financial statements.

[11/] Paragraphs 14-15 of Auditing Standard No. 5.

15. Also, AU sec. 316 indicates that the auditor should perform audit procedures to specifically address the risk of management override of controls including:

a. Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud (AU secs. 316.58-.62);

b. Reviewing accounting estimates for biases that could result in material misstatement due to fraud (AU secs. 316.63-.65); and

c. Evaluating the business rationale for significant unusual transactions (AU secs. 316.66-.67).

Testing Controls

Testing Controls in an Audit of Financial Statements

16. *Controls to be Tested.* If the auditor plans to assess control risk at less than the maximum by relying on controls,[12/] and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire **period of reliance**.[13/] However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

17. Also, tests of controls must be performed in the audit of financial statements for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence and when necessary to support the auditor's

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[12/] Reliance on controls that is supported by sufficient and appropriate audit evidence allows the auditor to assess control risk at less than the maximum, which results in a lower assessed risk of material misstatement. In turn, this allows the auditor to modify the nature, timing, and extent of planned substantive procedures.

[13/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

reliance on the accuracy and completeness of financial information used in performing other audit procedures.[14/]

> Note: When a significant amount of information supporting one or more relevant assertions is electronically initiated, recorded, processed, or reported, it might be impossible to design effective substantive tests that, by themselves, would provide sufficient appropriate evidence regarding the assertions. For such assertions, significant audit evidence may be available only in electronic form. In such cases, the sufficiency and appropriateness of the audit evidence usually depend on the effectiveness of controls over their accuracy and completeness. Furthermore, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively.

18. *Evidence about the Effectiveness of Controls in the Audit of Financial Statements.* In designing and performing tests of controls for the audit of financial statements, the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The auditor should obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. The auditor also should obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.

Testing Design Effectiveness

19. The auditor should test the design effectiveness of the controls selected for testing by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect error or fraud that could result in material misstatements in the financial statements.

[14/] Paragraph 10 of Auditing Standard No. 15, *Audit Evidence,* and paragraph .16 of AU sec. 329, *Substantive Analytical Procedures.*

Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.

20. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.[15/]

Testing Operating Effectiveness

21. The auditor should test the operating effectiveness of a control selected for testing by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

22. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Obtaining Evidence from Tests of Controls

23. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing might provide sufficient evidence in relation to the degree of reliance in an audit of financial statements.

Note: To obtain evidence about whether a control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures.

[15/] Paragraphs 37-38 of Auditing Standard No. 12 discuss performing a walkthrough.

Nature of Tests of Controls

24. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in the order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control.

> Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.

25. The nature of the tests of controls that will provide appropriate evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

> Note: A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain controls, might provide sufficient evidence about whether the control is effective.

Extent of Tests of Controls

26. The more extensively a control is tested, the greater the evidence obtained from that test.

27. Matters that could affect the necessary extent of testing of a control in relation to the degree of reliance on a control include the following:

- The frequency of the performance of the control by the company during the audit period;

- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control;

- The expected rate of deviation from a control;

- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control;
- The extent to which audit evidence is obtained from tests of other controls related to the assertion;
- The nature of the control, including, in particular, whether it is a manual control or an automated control; and
- For an automated control, the effectiveness of relevant information technology general controls.

> Note: AU sec. 350, *Audit Sampling,* establishes requirements regarding the use of sampling in tests of controls.

Timing of Tests of Controls

28. The timing of tests of controls relates to when the evidence about the operating effectiveness of the controls is obtained and the period of time to which it applies. Paragraph 16 of this standard indicates that the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance.

29. *Using Audit Evidence Obtained during an Interim Period.* When the auditor obtains evidence about the operating effectiveness of controls as of or through an interim date, he or she should determine what additional evidence is necessary concerning the operation of the controls for the remaining period of reliance.

30. The additional evidence that is necessary to update the results of testing from an interim date through the remaining period of reliance depends on the following factors:

- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date;

> Note: If there have been significant changes to the control since the interim date, the auditor should obtain evidence about the effectiveness of the new or modified control;

- The inherent risk associated with the related account(s) or assertion(s);
- The specific control tested prior to year end, including the nature of the control and the risk that the control is no longer effective during the remaining period, and the results of the tests of the control;
- The planned degree of reliance on the control;
- The sufficiency of the evidence of effectiveness obtained at an interim date; and
- The length of the remaining period.

31. *Using Audit Evidence Obtained in Past Audits.* For audits of financial statements, the auditor should obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies. When controls on which the auditor plans to rely have been tested in past audits and the auditor plans to use evidence about the effectiveness of those controls that was obtained in prior years, the auditor should take into account the following factors to determine the evidence needed during the current year audit to support the auditor's control risk assessments:

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) or assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls that the auditor has tested, especially controls that monitor other controls;
- The nature of the controls and the frequency with which they operate;

- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);

- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;

- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective);[16/]

- The complexity of the control and the significance of the judgments that must be made in connection with its operation;

- The planned degree of reliance on the control;

- The nature, timing, and extent of procedures performed in past audits;

- The results of the previous years' testing of the control;

- Whether there have been changes in the control or the process in which it operates since the previous audit; and

- For integrated audits, the evidence regarding the effectiveness of the controls obtained during the audit of internal control.

Assessing Control Risk

32. The auditor should assess control risk for relevant assertions by evaluating the evidence obtained from all sources, including the auditor's testing of controls for the audit of internal control and the audit of financial statements, misstatements detected during the financial statement audit, and any identified control deficiencies.

[16/] The auditor also may use a benchmarking strategy, when appropriate, for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B28 of Auditing Standard No. 5.

33. Control risk should be assessed at the maximum level for relevant assertions (1) for which controls necessary to sufficiently address the assessed risk of material misstatement in those assertions are missing or ineffective or (2) when the auditor has not obtained sufficient appropriate evidence to support a control risk assessment below the maximum level.

34. When deficiencies affecting the controls on which the auditor intends to rely are detected, the auditor should evaluate the severity of the deficiencies and the effect on the auditor's control risk assessments. If the auditor plans to rely on controls relating to an assertion but the controls that the auditor tests are ineffective because of control deficiencies, the auditor should:

a. Perform tests of other controls related to the same assertion as the ineffective controls, or

b. Revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased assessment of risk.

> Note: Auditing Standard No. 5 establishes requirements for evaluating the severity of a control deficiency and communicating identified control deficiencies to management and the audit committee in an integrated audit. AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements,* establishes requirements for communicating significant deficiencies and material weaknesses in an audit of financial statements only.

Testing Controls in an Audit of Internal Control

35. Auditing Standard No. 5 states that the objective of the tests of controls in an audit of internal control is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a point in time and taken as a whole.[17/] Auditing Standard No. 5 establishes requirements regarding the selection of controls to be tested and the

[17/] Paragraph B1 of Auditing Standard No. 5.

necessary nature, timing, and extent of tests of controls in an audit of internal control over financial reporting.

Substantive Procedures

36. The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.

37. As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures. Further, for an individual assertion, different combinations of the nature, timing, and extent of testing might provide sufficient appropriate evidence to respond to the assessed risk of material misstatement.

38. Internal control over financial reporting has inherent limitations,[18/] which, in turn, can affect the evidence that is needed from substantive procedures. For example, more evidence from substantive procedures ordinarily is needed for relevant assertions that have a higher susceptibility to management override or to lapses in judgment or breakdowns resulting from human failures.[19/]

Nature of Substantive Procedures

39. Substantive procedures generally provide persuasive evidence when they are designed and performed to obtain evidence that is relevant and reliable. Also, some types of substantive procedures, by their nature, produce more persuasive evidence than others. Inquiry alone does not provide sufficient appropriate evidence to support a conclusion about a relevant assertion.

> Note: Auditing Standard No. 15 discusses certain types of substantive procedures and the relevance and reliability of audit evidence.

[18/] Paragraph A5 of Auditing Standard No. 5.

[19/] See, e.g., paragraph .14 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures.*

40. Taking into account the types of potential misstatements in the relevant assertions that could result from identified risks, as required by paragraph 9.b., can help the auditor determine the types and combination of substantive audit procedures that are necessary to detect material misstatements in the respective assertions.

41. *Substantive Procedures Related to the Period-end Financial Reporting Process.* The auditor's substantive procedures must include the following audit procedures related to the period-end financial reporting process:

a. Reconciling the financial statements with the underlying accounting records; and

b. Examining material adjustments made during the course of preparing the financial statements.

> Note: AU secs. 316.58-.62 establish requirements for examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.

Extent of Substantive Procedures

42. The more extensively a substantive procedure is performed, the greater the evidence obtained from the procedure. The necessary extent of a substantive audit procedure depends on the materiality of the account or disclosure, the assessed risk of material misstatement, and the necessary degree of assurance from the procedure. However, increasing the extent of an audit procedure cannot adequately address an assessed risk of material misstatement unless the evidence to be obtained from the procedure is reliable and relevant.

Timing of Substantive Procedures

43. Performing certain substantive procedures at interim dates may permit early consideration of matters affecting the year-end financial statements, e.g., testing material transactions involving higher risks of misstatement. However, performing substantive procedures at an interim date without performing procedures at a later date increases the risk that a material misstatement could exist in the year-end financial statements that would not be detected by the auditor. This risk increases as the period between the interim date and year end increases.

44. In determining whether it is appropriate to perform substantive procedures at an interim date, the auditor should take into account the following:

a. The assessed risk of material misstatement, including:

(1) The auditor's assessment of control risk, as discussed in paragraphs 32-34;

(2) The existence of conditions or circumstances, if any, that create incentives or pressures on management to misstate the financial statements between the interim test date and the end of the period covered by the financial statements;

(3) The effects of known or expected changes in the company, its environment, or its internal control over financial reporting during the remaining period;

b. The nature of the substantive procedures;

c. The nature of the account or disclosure and relevant assertion; and

d. The ability of the auditor to perform the necessary audit procedures to cover the remaining period.

45. When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. Such procedures should include (a) comparing relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual and investigating such amounts and (b) performing audit procedures to test the remaining period.

46. If the auditor obtains evidence that contradicts the evidence on which the original risk assessments were based, including evidence of misstatements that he or she did not expect, the auditor should revise the related risk assessments and modify the planned nature, timing, or extent of substantive procedures covering the remaining period as necessary. Examples of such modifications include extending or repeating at the period end the procedures performed at the interim date.

Dual-purpose Tests

47. In some situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction (a "**dual-purpose test**"). In those situations, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested.[20/]

[20/] Paragraph .44 of AU sec. 350 discusses applying audit sampling in dual-purpose tests.

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Dual-purpose test – Substantive test of a transaction and a test of a control relevant to that transaction that are performed concurrently, e.g., a substantive test of sales transactions performed concurrently with a test of controls over those transactions.

A3. Period of reliance – The period being covered by the company's financial statements, or the portion of that period, for which the auditor plans to rely on controls in order to modify the nature, timing, and extent of planned substantive procedures.

APPENDIX 7

Auditing Standard No. 14

Evaluating Audit Results

Introduction

1. This standard establishes requirements regarding the auditor's evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.

Objective

2. The objective of the auditor is to evaluate the results of the audit to determine whether the audit evidence obtained is sufficient and appropriate to support the opinion to be expressed in the auditor's report.

Evaluating the Results of the Audit of Financial Statements

3. In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, the auditor should take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.

4. In the audit of financial statements,[1/] the auditor's evaluation of audit results should include evaluation of the following:

   a. The results of analytical procedures performed in the overall review of the financial statements ("overall review");

[1/] For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

b. **Misstatements** accumulated during the audit, including, in particular, **uncorrected misstatements**;[2/]

c. The qualitative aspects of the company's accounting practices;

d. Conditions identified during the audit that relate to the assessment of the risk of material misstatement due to fraud ("fraud risk");

e. The presentation of the financial statements, including the disclosures; and

f. The sufficiency and appropriateness of the audit evidence obtained.

Performing Analytical Procedures in the Overall Review

5. In the overall review, the auditor should read the financial statements and disclosures and perform analytical procedures to (a) evaluate the auditor's conclusions formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement.

6. As part of the overall review, the auditor should evaluate whether:

a. The evidence gathered in response to unusual or unexpected transactions, events, amounts, or relationships previously identified during the audit is sufficient; and

b. Unusual or unexpected transactions, events, amounts, or relationships[3/] indicate risks of material misstatement that were not identified previously, including, in particular, fraud risks.

[2/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

[3/] Paragraphs 46-48 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* and paragraph .03 of AU sec. 329, *Substantive Analytical Procedures.*

Note: If the auditor discovers a previously unidentified risk of material misstatement or concludes that the evidence gathered is not adequate, he or she should modify his or her audit procedures or perform additional procedures as necessary in accordance with paragraph 36 of this standard.

7. The nature and extent of the analytical procedures performed during the overall review may be similar to the analytical procedures performed as risk assessment procedures. The auditor should perform analytical procedures relating to revenue through the end of the reporting period.[4/]

8. The auditor should obtain corroboration for management's explanations regarding significant unusual or unexpected transactions, events, amounts, or relationships. If management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures to address the matter.

9. *Evaluating Whether Analytical Procedures Indicate a Previously Unrecognized Fraud Risk.* Whether an unusual or unexpected transaction, event, amount, or relationship indicates a fraud risk, as discussed in paragraph 6.b., depends on the relevant facts and circumstances, including the nature of the account or relationship among the data used in the analytical procedures. For example, certain unusual or unexpected transactions, events, amounts, or relationships could indicate a fraud risk if a component of the relationship involves accounts and disclosures that management has incentives or pressures to manipulate, e.g., significant unusual or unexpected relationships involving revenue and income.

Accumulating and Evaluating Identified Misstatements

10. *Accumulating Identified Misstatements.* The auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial.

Note: "Clearly trivial" is not another expression for "not material." Matters that are clearly trivial will be of a smaller order of magnitude than the

[4/] Paragraph 47 of Auditing Standard No. 12 contains a requirement to perform analytical procedures relating to revenue as part of the risk assessment procedures.

materiality level established in accordance with Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit,* and will be inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature, or circumstances. When there is any uncertainty about whether one or more items is clearly trivial, the matter is not considered trivial.

11. The auditor may designate an amount below which misstatements are clearly trivial and do not need to be accumulated. In such cases, the amount should be set so that any misstatements below that amount would not be material to the financial statements, individually or in combination with other misstatements, considering the possibility of undetected misstatement.

12. The auditor's accumulation of misstatements should include the auditor's best estimate of the total misstatement in the accounts and disclosures that he or she has tested, not just the amount of misstatements specifically identified. This includes misstatements related to accounting estimates, as determined in accordance with paragraph 13 of this standard, and projected misstatements from substantive procedures that involve audit sampling, as determined in accordance with AU sec. 350, *Audit Sampling.*[5/]

13. *Misstatements Relating to Accounting Estimates.* If the auditor concludes that the amount of an accounting estimate included in the financial statements is unreasonable or was not determined in conformity with the relevant requirements of the applicable financial reporting framework, he or she should treat the difference between that estimate and a reasonable estimate determined in conformity with the applicable accounting principles as a misstatement. If a range of reasonable estimates is supported by sufficient appropriate audit evidence and the recorded estimate is outside of the range of reasonable estimates, the auditor should treat the difference between the recorded accounting estimate and the closest reasonable estimate as a misstatement.

Note: If an accounting estimate is determined in conformity with the relevant requirements of the applicable financial reporting framework and the amount of the estimate is reasonable, a difference between an estimated amount best supported by the audit evidence and the recorded

[5/] AU sec. 350.26.

amount of the accounting estimate ordinarily would not be considered to be a misstatement. Paragraph 27 discusses evaluating accounting estimates for bias.

14. *Considerations as the Audit Progresses.* The auditor should determine whether the overall audit strategy and audit plan need to be modified if:

a. The nature of accumulated misstatements and the circumstances of their occurrence indicate that other misstatements might exist that, in combination with accumulated misstatements, could be material; or

b. The aggregate of misstatements accumulated during the audit approaches the materiality level or levels used in planning and performing the audit.[6/]

> Note: When the aggregate of accumulated misstatements approaches the materiality level or levels used in planning and performing the audit, there likely will be greater than an appropriately low level of risk that possible undetected misstatements, when combined with the aggregate of misstatements accumulated during the audit that remain uncorrected, could be material to the financial statements. If the auditor's assessment of this risk is unacceptably high, he or she should perform additional audit procedures or determine that management has adjusted the financial statements so that the risk that the financial statements are materially misstated has been reduced to an appropriately low level.

15. The auditor should communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them.

16. If management has examined an account or a disclosure in response to misstatements detected by the auditor and has made corrections to the account or disclosure, the auditor should evaluate management's work to determine whether the corrections have been recorded properly and whether uncorrected misstatements remain.

[6/] Auditing Standard No. 11.

17. *Evaluation of the Effect of Uncorrected Misstatements.* The auditor should evaluate whether uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.[7/] (See Appendix B.)

> Note: In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." [8/] As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him …."[9/]

> Note: As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility[10/] that it could lead to a material contingent liability or a material loss of revenue.[11/] Also,

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7/ If the financial statements contain material misstatements, AU sec. 508, *Reports on Audited Financial Statements*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

8/ TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

9/ TSC Industries, 426 U.S. at 450.

10/ There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

11/ AU sec. 317, *Illegal Acts by Clients.*

a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

Note: If the reevaluation of the established materiality level or levels, as set forth in Auditing Standard No. 11,[12/] results in a lower amount for the materiality level or levels, the auditor should take into account that lower materiality level or levels in the evaluation of uncorrected misstatements.

18. The auditor's evaluation of uncorrected misstatements, as described in paragraph 17 of this standard, should include evaluation of the effects of uncorrected misstatements detected in prior years and misstatements detected in the current year that relate to prior years.

19. The auditor cannot assume that an instance of error or fraud is an isolated occurrence. Therefore, the auditor should evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement. This evaluation is important in determining whether the risk assessments remain appropriate, as discussed in paragraph 36 of this standard.

20. *Evaluating Whether Misstatements Might Be Indicative of Fraud.* The auditor should evaluate whether identified misstatements[13/] might be indicative of fraud and, in turn, how they affect the auditor's evaluation of materiality and the related audit responses. As indicated in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, fraud is an intentional act that results in material misstatement of the financial statements.[14/]

21. If the auditor believes that a misstatement is or might be intentional, and if the effect on the financial statements could be material or cannot be readily determined, the auditor should perform procedures to obtain additional audit evidence to determine whether fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements and the auditor's report thereon.

[12/] Paragraphs 11-12 of Auditing Standard No. 11.

[13/] Misstatements include omission and presentation of inaccurate or incomplete disclosures.

[14/] AU sec. 316.05.

22. For misstatements that the auditor believes are or might be intentional, the auditor should evaluate the implications on the integrity of management or employees and the possible effect on other aspects of the audit. If the misstatement involves higher-level management, it might be indicative of a more pervasive problem, such as an issue with the integrity of management, even if the amount of the misstatement is small. In such circumstances, the auditor should reevaluate the assessment of fraud risk and the effect of that assessment on (a) the nature, timing, and extent of the necessary tests of accounts or disclosures and (b) the assessment of the effectiveness of controls. The auditor also should evaluate whether the circumstances or conditions indicate possible collusion involving employees, management, or external parties and, if so, the effect of the collusion on the reliability of evidence obtained.

23. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, he or she also must determine his or her responsibilities under AU secs. 316.79-.82A, AU sec. 317, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1.

Evaluating the Qualitative Aspects of the Company's Accounting Practices

24. When evaluating whether the financial statements as a whole are free of material misstatement, the auditor should evaluate the qualitative aspects of the company's accounting practices, including potential bias in management's judgments about the amounts and disclosures in the financial statements.

25. The following are examples of forms of management bias:

a. The selective correction of misstatements brought to management's attention during the audit (e.g., correcting misstatements that have the effect of increasing reported earnings but not correcting misstatements that have the effect of decreasing reported earnings).

   Note: To evaluate the potential effect of selective correction of misstatements, the auditor should obtain an understanding of the reasons that management decided not to correct misstatements communicated by the auditor in accordance with paragraph 15.

b. The identification by management of additional adjusting entries that offset misstatements accumulated by the auditor. If such adjusting entries are identified, the auditor should perform procedures to determine why the underlying misstatements were not identified previously and evaluate the implications on the integrity of management and the auditor's risk assessments, including fraud risk assessments. The auditor also should perform additional procedures as necessary to address the risk of further undetected misstatement.

c. Bias in the selection and application of accounting principles.[15/]

d. Bias in accounting estimates.[16/]

26. If the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. Also, the auditor should evaluate whether the auditor's risk assessments, including, in particular, the assessment of fraud risks, and the related audit responses remain appropriate.

27. *Evaluating Bias in Accounting Estimates.* The auditor should evaluate whether the difference between estimates best supported by the audit evidence and estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the company's management. If each accounting estimate included in the financial statements was individually reasonable but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase earnings or loss, the auditor should evaluate whether these circumstances indicate potential management bias in the estimates. Bias also can result from the cumulative effect of changes in multiple accounting estimates. If the estimates in the financial statements are grouped at one end of the range of reasonable estimates in the prior year and are grouped at the other end of the range of reasonable estimates in the current year, the auditor should evaluate whether management is using swings in estimates to achieve an expected or desired outcome, e.g., to offset higher or lower than expected earnings.

[15/] Paragraph 5.d. of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

[16/] Paragraph 27 of this standard.

Note: AU secs. 316.64-.65 establish requirements regarding performing a retrospective review of accounting estimates and evaluating the potential for fraud risks.

Evaluating Conditions Relating to the Assessment of Fraud Risks

28. When evaluating the results of the audit, the auditor should evaluate whether the accumulated results of auditing procedures[17/] and other observations affect the assessment of the fraud risks made throughout the audit and whether the audit procedures need to be modified to respond to those risks. (See Appendix C.)

29. As part of this evaluation, the engagement partner should determine whether there has been appropriate communication with the other engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks.

Note: To accomplish this communication, the engagement partner might arrange another discussion among the engagement team members about fraud risks. (See paragraphs 49-51 of Auditing Standard No. 12.)

Evaluating the Presentation of the Financial Statements, Including the Disclosures

30. The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

Note: AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles,* establishes requirements for evaluating the presentation of the financial statements. Auditing Standard No. 6, *Evaluating Consistency of Financial Statements,* establishes requirements regarding evaluating the consistency of the accounting principles used in financial statements.

[17/] Such auditing procedures include, but are not limited to, procedures in the overall review (paragraph 9 of this standard), the evaluation of identified misstatements (paragraphs 20-23 of this standard), and the evaluation of the qualitative aspects of the company's accounting practices (paragraphs 24-27 of this standard).

Note: The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

31. As part of the evaluation of the presentation of the financial statements, the auditor should evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework. Evaluation of the information disclosed in the financial statements includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

Note: According to AU sec. 508, if the financial statements, including the accompanying notes, fail to disclose information that is required by the applicable financial reporting framework, the auditor should express a qualified or adverse opinion and should provide the information in the report, if practicable, unless its omission from the report is recognized as appropriate by a specific auditing standard.[18/]

Evaluating the Sufficiency and Appropriateness of Audit Evidence

32. Auditing Standard No. 8, *Audit Risk,* states:

To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.[19/]

[18/] AU secs. 508.41-.44.

[19/] Paragraph 3 of Auditing Standard No. 8.

33. As part of evaluating audit results, the auditor must conclude on whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements.

34. Factors that are relevant to the conclusion on whether sufficient appropriate audit evidence has been obtained include the following:

a. The significance of uncorrected misstatements and the likelihood of their having a material effect, individually or in combination, on the financial statements, considering the possibility of further undetected misstatement (paragraphs 14 and 17-19 of this standard).

b. The results of audit procedures performed in the audit of financial statements, including whether the evidence obtained supports or contradicts management's assertions and whether such audit procedures identified specific instances of fraud (paragraphs 20-23 and 28-29 of this standard).

c. The auditor's risk assessments (paragraph 36 of this standard).

d. The results of audit procedures performed in the audit of internal control over financial reporting, if the audit is an integrated audit.

e. The appropriateness (i.e., the relevance and reliability) of the audit evidence obtained.[20/]

35. If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion or has substantial doubt about a relevant assertion, the auditor should perform procedures to obtain further audit evidence to address the matter. If the auditor is unable to obtain sufficient appropriate audit evidence to have a reasonable basis to conclude about whether the financial statements as a whole are free of material

[20/] Paragraphs 7-9 of Auditing Standard No. 15, *Audit Evidence,* discuss the relevance and reliability of audit evidence.

misstatement, AU sec. 508 indicates that the auditor should express a qualified opinion or a disclaimer of opinion.[21/]

36. *Evaluating the Appropriateness of Risk Assessments.* As part of the evaluation of whether sufficient appropriate audit evidence has been obtained, the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate and whether the audit procedures need to be modified or additional procedures need to be performed as a result of any changes in the risk assessments. For example, the re-evaluation of the auditor's risk assessments could result in the identification of relevant assertions or significant risks that were not identified previously and for which the auditor should perform additional audit procedures.

> Note: Auditing Standard No. 12 establishes requirements on revising the auditor's risk assessment.[22/] Auditing Standard No. 13 discusses the auditor's responsibilities regarding the assessment of control risk and evaluation of control deficiencies in an audit of financial statements.[23/]

Evaluating the Results of the Audit of Internal Control Over Financial Reporting

37. Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* indicates that the auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit, and any identified control deficiencies. Auditing Standard No. 5 describes the auditor's responsibilities regarding

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21/ AU sec. 508.22-.34 contains requirements regarding audit scope limitations.

22/ Paragraph 74 of Auditing Standard No. 12.

23/ Paragraphs 32-34 of Auditing Standard No. 13.

evaluating the results of the audit, including evaluating the identified control deficiencies.[24/]

[24/] Paragraphs 62-70 of Auditing Standard No. 5 discuss evaluating identified control deficiencies, and paragraphs 71-73 of Auditing Standard No. 5 discuss forming an opinion on the effectiveness of internal control over financial reporting.

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Misstatement – A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework.[1/] A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework. Misstatements can arise from error (i.e., unintentional misstatement) or fraud.[2/]

A3. Uncorrected misstatements – Misstatements, other than those that are clearly trivial,[3/] that management has not corrected.

[1/] The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

[2/] Paragraph .02 of AU sec. 316*, Consideration of Fraud in a Financial Statement Audit.*

[3/] Paragraph 10 of this standard states that, "[t]he auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial."

APPENDIX B – Qualitative Factors Related to the Evaluation of the Materiality of Uncorrected Misstatements

B1. Paragraph 17 of this standard states:

> The auditor should evaluate whether uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.[1/]
>
> > Note: In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[2/] As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him …."[3/]
> >
> > Note: As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a

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[1/] If the financial statements contain material misstatements, AU sec. 508, *Reports on Audited Financial Statements*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

[2/] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

[3/] TSC Industries, 426 U.S. at 450.

reasonable possibility[4/] that it could lead to a material contingent liability or a material loss of revenue.[5/] Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

B2. Qualitative factors to consider in the auditor's evaluation of the materiality of uncorrected misstatements, if relevant, include the following:

a. The potential effect of the misstatement on trends, especially trends in profitability.

b. A misstatement that changes a loss into income or vice versa.

c. The effect of the misstatement on segment information, for example, the significance of the matter to a particular segment important to the future profitability of the company, the pervasiveness of the matter on the segment information, and the impact of the matter on trends in segment information, all in relation to the financial statements taken as a whole.

d. The potential effect of the misstatement on the company's compliance with loan covenants, other contractual agreements, and regulatory provisions.

e. The existence of statutory or regulatory reporting requirements that affect materiality thresholds.

f. A misstatement that has the effect of increasing management's compensation, for example, by satisfying the requirements for the award of bonuses or other forms of incentive compensation.

[4/] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

[5/] AU sec. 317, *Illegal Acts by Clients.*

g. The sensitivity of the circumstances surrounding the misstatement, for example, the implications of misstatements involving fraud and possible illegal acts, violations of contractual provisions, and conflicts of interest.

h. The significance of the financial statement element affected by the misstatement, for example, a misstatement affecting recurring earnings as contrasted to one involving a non-recurring charge or credit, such as an extraordinary item.

i. The effects of misclassifications, for example, misclassification between operating and non-operating income or recurring and non-recurring income items.

j. The significance of the misstatement or disclosures relative to known user needs, for example:

- The significance of earnings and earnings per share to public company investors.

- The magnifying effects of a misstatement on the calculation of purchase price in a transfer of interests (buy/sell agreement).

- The effect of misstatements of earnings when contrasted with expectations.

k. The definitive character of the misstatement, for example, the precision of an error that is objectively determinable as contrasted with a misstatement that unavoidably involves a degree of subjectivity through estimation, allocation, or uncertainty.

l. The motivation of management with respect to the misstatement, for example, (i) an indication of a possible pattern of bias by management when developing and accumulating accounting estimates or (ii) a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process.

m. The existence of offsetting effects of individually significant but different misstatements.

n. The likelihood that a misstatement that is currently immaterial may have a material effect in future periods because of a cumulative effect, for example, that builds over several periods.

o. The cost of making the correction − it may not be cost-beneficial for the client to develop a system to calculate a basis to record the effect of an immaterial misstatement. On the other hand, if management appears to have developed a system to calculate an amount that represents an immaterial misstatement, it may reflect a motivation of management as noted in paragraph B2.l above.

p. The risk that possible additional undetected misstatements would affect the auditor's evaluation.

APPENDIX C – Matters That Might Affect the Assessment of Fraud Risks

C1. If the following matters are identified during the audit, the auditor should take into account these matters in the evaluation of the assessment of fraud risks, as discussed in paragraph 28 of this standard:

a. Discrepancies in the accounting records, including:

(1) Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or company policy.

(2) Unsupported or unauthorized balances or transactions.

(3) Last-minute adjustments that significantly affect financial results.

(4) Evidence of employees' access to systems and records that is inconsistent with the access that is necessary to perform their authorized duties.

(5) Tips or complaints to the auditor about alleged fraud.

b. Conflicting or missing evidence, including:

(1) Missing documents.

(2) Documents that appear to have been altered.[1/]

(3) Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.

(4) Significant unexplained items in reconciliations.

(5) Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.

[1/] Paragraph 9 of Auditing Standard No. 15, *Audit Evidence.*

(6) Unusual discrepancies between the company's records and confirmation responses.

(7) Missing inventory or physical assets of significant magnitude.

(8) Unavailable or missing electronic evidence that is inconsistent with the company's record retention practices or policies.

(9) Inability to produce evidence of key systems development and program change testing and implementation activities for current year system changes and deployments.

(10) Unusual balance sheet changes or changes in trends or important financial statement ratios or relationships, e.g., receivables growing faster than revenues.

(11) Large numbers of credit entries and other adjustments made to accounts receivable records.

(12) Unexplained or inadequately explained differences between the accounts receivable subsidiary ledger and the general ledger control account, or between the customer statement and the accounts receivable subsidiary ledger.

(13) Missing or nonexistent cancelled checks in circumstances in which cancelled checks are ordinarily returned to the company with the bank statement.

(14) Fewer responses to confirmation requests than anticipated or a greater number of responses than anticipated.

c. Problematic or unusual relationships between the auditor and management, including:

(1) Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought, including:[2/]

[2/] Denial of access to information might constitute a limitation on the scope of the audit that requires the auditor to qualify or disclaim an opinion. (See Auditing

a. Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.

b. Denial of access to key information technology operations staff and facilities, including security, operations, and systems development.

(2) Undue time pressures imposed by management to resolve complex or contentious issues.

(3) Management pressure on engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.

(4) Unusual delays by management in providing requested information.

(5) Management's unwillingness to add or revise disclosures in the financial statements to make them more complete and transparent.

(6) Management's unwillingness to appropriately address significant deficiencies in internal control on a timely basis.

d. Other matters, including:

(1) Objections by management to the auditor meeting privately with the audit committee.

(2) Accounting policies that appear inconsistent with industry practices that are widely recognized and prevalent.

(3) Frequent changes in accounting estimates that do not appear to result from changing circumstances.

(4) Tolerance of violations of the company's code of conduct.

Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and AU sec. 508, *Reports on Audited Financial Statements.*)

APPENDIX 8

Auditing Standard No. 15

Audit Evidence

Introduction

1. This standard explains what constitutes audit evidence and establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.

2. Audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and information that contradicts such assertions.

Objective

3. The objective of the auditor is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report.[1/]

Sufficient Appropriate Audit Evidence

4. The auditor must plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion.

5. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the following:

[1/] Auditing Standard No. 14, *Evaluating Audit Results,* establishes requirements regarding evaluating whether sufficient appropriate evidence has been obtained. Auditing Standard No. 3, *Audit Documentation,* establishes requirements regarding documenting the procedures performed, evidence obtained, and conclusions reached in an audit.

- *Risk of material misstatement (in the audit of financial statements) or the risk associated with the control (in the audit of internal control over financial reporting).* As the risk increases, the amount of evidence that the auditor should obtain also increases. For example, ordinarily more evidence is needed to respond to significant risks.[2/]

- *Quality of the audit evidence obtained.* As the quality of the evidence increases, the need for additional corroborating evidence decreases. Obtaining more of the same type of audit evidence, however, cannot compensate for the poor quality of that evidence.

6. Appropriateness is the measure of the quality of audit evidence, i.e., its relevance and reliability. To be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based.

Relevance and Reliability

7. *Relevance.* The relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The relevance of audit evidence depends on:

   a. The design of the audit procedure used to test the assertion or control, in particular whether it is designed to (1) test the assertion or control directly and (2) test for understatement or overstatement; and

   b. The timing of the audit procedure used to test the assertion or control.

8. *Reliability.* The reliability of evidence depends on the nature and source of the evidence and the circumstances under which it is obtained. For example, in general:

- Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources.

- The reliability of information generated internally by the company is increased when the company's controls over that information are effective.

[2/] Paragraph A5 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

- Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.

- Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized, or otherwise converted into electronic form, the reliability of which depends on the controls over the conversion and maintenance of those documents.

9. The auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should evaluate the effect, if any, on the other aspects of the audit.

Using Information Produced by the Company

10. When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to:[3/]

- Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and

- Evaluate whether the information is sufficiently precise and detailed for purposes of the audit.

Financial Statement Assertions

11. In representing that the financial statements are presented fairly in conformity with the applicable financial reporting framework, management implicitly or explicitly

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[3/] When using the work of a specialist engaged or employed by management, see AU sec. 336, *Using the Work of a Specialist.* When using information produced by a service organization or a service auditor's report as audit evidence, see AU sec. 324, *Service Organizations*, and for integrated audits, see Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of financial statements and related disclosures. Those assertions can be classified into the following categories:

- *Existence or occurrence* – Assets or liabilities of the company exist at a given date, and recorded transactions have occurred during a given period.

- *Completeness* – All transactions and accounts that should be presented in the financial statements are so included.

- *Valuation or allocation* – Asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts.

- *Rights and obligations* – The company holds or controls rights to the assets, and liabilities are obligations of the company at a given date.

- *Presentation and disclosure* – The components of the financial statements are properly classified, described, and disclosed.

12. The auditor may base his or her work on financial statement assertions that differ from those in this standard if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement in each significant account and disclosure that has a reasonable possibility[4/] of containing misstatements that would cause the financial statements to be materially misstated, individually or in combination with other misstatements.[5/]

4/ There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

5/ For an integrated audit, also see paragraph 28 of Auditing Standard No. 5.

Audit Procedures for Obtaining Audit Evidence

13. Audit procedures can be classified into the following categories:

a. Risk assessment procedures,[6/] and

b. Further audit procedures,[7/] which consist of:

(1) Tests of controls, and

(2) Substantive procedures, including tests of details and substantive analytical procedures.

14. Paragraphs 15-21 of this standard describe specific audit procedures. The purpose of an audit procedure determines whether it is a risk assessment procedure, test of controls, or substantive procedure.

Inspection

15. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or physically examining an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorization.

Observation

16. Observation consists of looking at a process or procedure being performed by others, e.g., the auditor's observation of inventory counting by the company's personnel or the performance of control activities. Observation can provide audit evidence about the performance of a process or procedure, but the evidence is limited to the point in

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[6/] Auditing Standard No. 12.

[7/] Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

time at which the observation takes place and also is limited by the fact that the act of being observed may affect how the process or procedure is performed.[8/]

Inquiry

17. Inquiry consists of seeking information from knowledgeable persons in financial or nonfinancial roles within the company or outside the company. Inquiry may be performed throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.[9/]

> Note: Inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.

Confirmation

18. A confirmation response represents a particular form of audit evidence obtained by the auditor from a third party in accordance with PCAOB standards.[10/]

Recalculation

19. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

[8/] AU sec. 331, *Inventories,* establishes requirements regarding observation of the counting of inventory.

[9/] AU sec. 333, *Management Representations,* establishes requirements regarding written management representations, including confirmation of management responses to oral inquiries.

[10/] AU sec. 330, *The Confirmation Process.*

Reperformance

20. Reperformance involves the independent execution of procedures or controls that were originally performed by company personnel.

Analytical Procedures

21. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass the investigation of significant differences from expected amounts.[11/]

Selecting Items for Testing to Obtain Audit Evidence

22. Designing substantive tests of details and tests of controls includes determining the means of selecting items for testing from among the items included in an account or the occurrences of a control. The auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. The alternative means of selecting items for testing are:

- Selecting all items;
- Selecting specific items; and
- Audit sampling.

23. The particular means or combination of means of selecting items for testing that is appropriate depends on the nature of the audit procedure, the characteristics of the control or the items in the account being tested, and the evidence necessary to meet the objective of the audit procedure.

[11/] AU sec. 329, *Substantive Analytical Procedures,* establishes requirements on performing analytical procedures as substantive procedures.

Selecting All Items

24. Selecting all items (100 percent examination) refers to testing the entire population of items in an account or the entire population of occurrences of a control (or an entire stratum within one of those populations). The following are examples of situations in which 100 percent examination might be applied:

- The population constitutes a small number of large value items;
- The audit procedure is designed to respond to a significant risk, and other means of selecting items for testing do not provide sufficient appropriate audit evidence; and
- The audit procedure can be automated effectively and applied to the entire population.

Selecting Specific Items

25. Selecting specific items refers to testing all of the items in a population that have a specified characteristic, such as:

- *Key items.* The auditor may decide to select specific items within a population because they are important to accomplishing the objective of the audit procedure or exhibit some other characteristic, e.g., items that are suspicious, unusual, or particularly risk-prone or items that have a history of error.
- *All items over a certain amount.* The auditor may decide to examine items whose recorded values exceed a certain amount to verify a large proportion of the total amount of the items included in an account.

26. The auditor also might select specific items to obtain an understanding about matters such as the nature of the company or the nature of transactions.

27. The application of audit procedures to items that are selected as described in paragraphs 25-26 of this standard does not constitute audit sampling, and the results of those audit procedures cannot be projected to the entire population.[12/]

Audit Sampling

28. Audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.[13/]

Inconsistency in, or Doubts about the Reliability of, Audit Evidence

29. If audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

[12/] If misstatements are identified in the selected items, see paragraphs 12-13 and paragraphs 17-19 of Auditing Standard No. 14.

[13/] AU sec. 350, *Audit Sampling,* establishes requirements regarding audit sampling.

APPENDIX 9

Amendments to PCAOB Standards

Auditing Standards

AU sec. 110, "Responsibilities and Functions of the Independent Auditor"

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures" section 110, "Responsibilities and Functions of the Independent Auditor" (AU sec. 110, "Responsibilities and Functions of the Independent Auditor"), as amended, is amended as follows:

Within footnote 1 to paragraph .02, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit.*

AU sec. 150, "Generally Accepted Auditing Standards"

SAS No. 95, "Generally Accepted Auditing Standards" (AU sec. 150, "Generally Accepted Auditing Standards"), as amended, is amended as follows:

a. Within paragraph .02, in the third standard of field work, the word "competent" is replaced with the word "appropriate."

b. Footnote 2 to paragraph .04 is deleted.

AU sec. 210, "Training and Proficiency of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 210, "Training and Proficiency of the Independent Auditor" (AU sec. 210, "Training and Proficiency of the Independent Auditor "), as amended, is amended as follows:

The last sentence of paragraph .03 is replaced with:

The engagement partner must exercise seasoned judgment in the varying degrees of his supervision and review of the work done and judgments exercised by his subordinates, who in turn must meet the responsibilities attaching to the varying gradations and functions of their work.

AU sec. 230, "Due Professional Care in the Performance of Work"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 230, "Due Professional Care in the Performance of Work" (AU sec. 230, "Due Professional Care in the Performance of Work"), as amended, is amended as follows:

a. The second and third sentences of paragraph .06 are replaced with:

   The engagement partner should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client. The engagement partner is responsible for the assignment of tasks to, and supervision of, the members of the engagement team.[fn4]

b. Footnote 3 to paragraph .06 is deleted.

c. Within footnote 4 to paragraph .06, the phrase "See section 311.11" is replaced with, "See Auditing Standard No. 10, *Supervision of the Audit Engagement*."

d. Footnote 6 to paragraph .11 is deleted.

e. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

f. At the end of the fifth sentence of paragraph .12, the following parenthetical is added: "(See paragraph 9 of Auditing Standard No. 15, *Audit Evidence*.)"

AU sec. 310, "Appointment of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 310, "Appointment of the Independent Auditor" (AU sec. 310, "Appointment of the Independent Auditor"), as amended, is amended as follows:

a. Within footnote ** to the title of the standard, the sentence "(See section 313.)" is deleted.

b. Paragraph .02 is replaced with:

Audit planning is discussed in Auditing Standard No. 9, *Audit Planning*, and supervision of engagement team members is discussed in Auditing Standard No. 10, *Supervision of the Audit Engagement.*

c. In paragraph .03, the sentence "(See section 313)" is deleted.

d. Within footnote 3 to paragraph .06, the reference to Section 312, *Audit Risk and Materiality in Conducting an Audit,* paragraph .04, is replaced with a reference to Paragraph A2 of Auditing Standard No. 14, *Evaluating Audit Results.*

AU sec. 311, "Planning and Supervision"

SAS No. 22, "Planning and Supervision" (AU sec. 311, "Planning and Supervision"), as amended, is superseded.

AU sec. 9311, "Planning and Supervision: Auditing Interpretations of Section 311"

AU sec. 9311, "Planning and Supervision: Auditing Interpretations of Section 311", as amended, is superseded.

AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"

SAS No. 47, "Audit Risk and Materiality in Conducting an Audit" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), as amended, is superseded.

AU sec. 9312, "Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312"

AU sec. 9312, "Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312" is superseded.

AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"

SAS No. 45, "Omnibus Statement on Auditing Standards – 1983" (AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"), as amended, is superseded.

AU sec. 315, "Communications Between Predecessor and Successor Auditors"

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows:

a. In the first sentence of paragraph .12, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .18, the word "competent" is replaced with the word "appropriate."

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

a. The second sentence of paragraph .01 is replaced with:

   This section establishes requirements and provides direction relevant to fulfilling that responsibility, as it relates to fraud, in an audit of financial statements. [fn 2]

b. In footnote 1 to paragraph .01, delete the following information: (see section 312, *Audit Risk and Materiality in Conducting an Audit*," and the closing parenthesis at the end of that sentence.

c. Footnote 2 to paragraph .01 is replaced with:

   For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

d. The following paragraph .01A is added:

   Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements. Auditing Standard No. 13, *The Auditor's Responses* to *the Risks of Material Misstatement,* establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement. Auditing Standard No. 14, *Evaluating Audit Results,* establishes requirements regarding the auditor's evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.

e. In paragraph .02:

- The third through the sixth bullet points are deleted.

- The seventh bullet point is replaced with:

  Responding to fraud risks. This section discusses certain responses to fraud risks involving the nature, timing, and extent of audit procedures, including:

  - o Responses to assessed fraud risks relating to fraudulent financial reporting and misappropriation of assets (see paragraphs .52 through .56).

  - o Responses to specifically address the fraud risks arising from management override of internal controls (see paragraphs .57 through .67).

- The eighth bullet point is deleted.

f. Paragraph .03 is deleted.

g. Footnote 5 to paragraph .06 is replaced with:

The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

h. In the third sentence of paragraph .13, the term "the risk of material misstatement due to fraud" is replaced with the term "fraud risks."

i. Paragraphs .14 through .45 are deleted, along with the preceding heading, "Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud."

j. Footnotes 8 through 19 related to paragraphs .14 through .45 are deleted.

k. Paragraphs .46 through .50 are deleted. The heading preceding paragraph .46, "Responding to the Results of the Assessment," is replaced with the heading "Responding to Assessed Fraud Risks."

l. Paragraph .51 is deleted. The heading preceding paragraph .51, "Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed to Address the Identified Risks," is replaced with the heading "Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed."

m. Paragraph .52 is replaced with:

Paragraph 8 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement,* states that "[t]he auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement due to error or fraud for each relevant assertion of each significant account and disclosure." Paragraph 12 of Auditing Standard No. 13 states that "the audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected."

> Note: Paragraph 71.b. of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, states that a fraud risk is a significant risk. Accordingly, the requirement for responding to significant risks also applies to fraud risks.

n. In paragraph .53:

- The first sentence is replaced with:

  The following are examples of responses to assessed fraud risks involving the nature, timing, and extent of audit procedures:

- The fifth bullet point is replaced with:

  Interviewing personnel involved in activities in areas in which a fraud risk has been identified to obtain their insights about the risk and how controls address the risk. (See paragraph 54 of Auditing

Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*)

- In the sixth bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

o. Footnote 20 to paragraph .53 is replaced with:

AU sec. 329, *Substantive Analytical Procedures*, establishes requirements regarding performing analytical procedures as substantive tests.

p. The heading preceding paragraph .54, "Additional Examples of Responses to Identified Risks of Misstatements Arising From Fraudulent Financial Reporting," is replaced with the heading "Additional Examples of Audit Procedures Performed to Respond to Assessed Fraud Risks Relating to Fraudulent Financial Reporting."

q. The first sentence in paragraph .54 is replaced with:

The following are additional examples of audit procedures that might be performed in response to assessed fraud risks relating to fraudulent financial reporting:

r. In paragraph .54:

- In the last sentence of the first bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."
- In the first sentence of the second bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."
- In the first sentence of the third bullet point and the accompanying paragraph to the third bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

s. Footnotes 21 and 22 to paragraph .54 are amended as follows:

- The text of footnote 21 is replaced with "AU sec. 330, *The Confirmation Process*, establishes requirements regarding the confirmation process in audits of financial statements."

- The text of footnote 22 is replaced with "AU sec. 336, *Using the Work of a Specialist*, establishes requirements for an auditor who uses the work of a specialist in performing an audit of financial statements."

t. The heading preceding paragraph .55, "Examples of Responses to Identified Risks of Misstatements Arising From Misappropriations of Assets," is replaced with the heading "Examples of Audit Procedures Performed to Respond to Fraud Risks Relating to Misappropriations of Assets."

u. In the first sentence of paragraph .55, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

v. In paragraph .56:

- The first and second sentences are replaced with:

  The audit procedures performed in response to a fraud risk relating to misappropriation of assets usually will be directed toward certain account balances. Although some of the audit procedures noted in paragraphs .53 and .54 and in paragraphs 8 through 15 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement,* may apply in such circumstances, such as the procedures directed at inventory quantities, the scope of the work should be linked to the specific information about the misappropriation risk that has been identified.

- In the third sentence, the words "design and" are added before the words "operating effectiveness."

w. The heading preceding paragraph .57, "Responses to Further Address the Risk of Management Override of Controls," is replaced with the heading "Audit Procedures Performed to Specifically Address the Risk of Management Override of Controls."

x. The third sentence of paragraph .57 is replaced with:

Accordingly, as part of the auditor's responses that address fraud risks, the procedures described in paragraphs .58 through .67 should be performed to specifically address the risk of management override of controls.

y. Footnote 23 to paragraph .58 is replaced with:

See paragraphs 28 through 32 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

z. In paragraph .61:

- In the first sentence of the first bullet point, the term "the risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- In the second bullet point, the last two sentences are replaced with the following:

  Effective controls over the preparation and posting of journal entries and adjustments may affect the extent of substantive testing necessary, provided that the auditor has tested the controls. However, even though controls might be implemented and operating effectively, the auditor's substantive procedures for testing journal entries and other adjustments should include the identification and substantive testing of specific items.

- In item (f) of the fifth bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

- The last sentence of the fifth bullet point is replaced with:

  In audits of entities that have multiple locations or business units, the auditor should determine whether to select journal entries from locations based on factors set forth in paragraphs 11 through 14 of Auditing Standard No. 9, *Audit Planning*.

aa. The last sentence of paragraph .63 is replaced with:

Paragraphs 24 through 27 of Auditing Standard No. 14, *Evaluating Audit Results,* discuss the auditor's responsibilities for assessing bias in accounting estimates and the effect of bias on the financial statements.

bb. Paragraphs .68 through .78 are deleted, along with the preceding heading "Evaluating Audit Evidence."

cc. Footnotes 26 through 36 related to paragraphs .68 through .78 are deleted.

dd. In the first sentence of paragraph .80, the term "risks of material misstatement due to fraud" is replaced with the term "fraud risks."

ee. The last sentence of paragraph .80 is replaced with:

The auditor also should evaluate whether the absence of or deficiencies in controls that address fraud risks or otherwise help prevent, deter, and detect fraud (see paragraphs 72-73 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*) represent significant deficiencies or material weaknesses that should be communicated to senior management and the audit committee.

ff. The first sentence of paragraph .81 is replaced with:

The auditor also should consider communicating other fraud risks, if any, identified by the auditor.

gg. In paragraph .83:

- The reference in the first bullet point to paragraphs .14 through .17 is replaced with a reference to paragraphs 52 and 53 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

- The term "risks of material misstatement due to fraud" in the first sentence of the second bullet point is replaced with the term "fraud risks." The reference in the second bullet point to paragraphs .19 through .34 is replaced with references to paragraph 47, paragraphs 56 through 58, and paragraphs 65 through 69 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

- The third bullet point is replaced with:

  The fraud risks that were identified at the financial statement and assertion levels (see paragraphs 59 through 69 of Auditing

Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*), and the linkage of those risks to the auditor's response (see paragraphs 5 through 15 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*).

- Within the fourth bullet point, the term "risk of material misstatement due to fraud" in the first sentence is replaced with the term "fraud risk," and the reference to paragraph .41 is replaced with a reference to paragraph 68 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

- The fifth bullet point is replaced with:

  The results of the procedures performed to address the assessed fraud risks, including those procedures performed to further address the risk of management override of controls (See paragraph 15 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatements.*)

- The reference in the sixth bullet point to paragraphs .68 through .73 is replaced with a reference to paragraphs 5 through 9 of Auditing Standard No. 14, *Evaluating Audit Results*.

hh. Paragraph .84 and the heading preceding this paragraph, "Effective Date," are deleted.

ii. The first sentence of paragraph .85 is replaced with:

This appendix contains examples of risk factors discussed in paragraphs 65 through 69 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

<u>AU sec. 317, "Illegal Acts by Clients"</u>

SAS No. 54, "Illegal Acts by Clients" (AU sec. 317, "Illegal Acts by Clients") is amended as follows:

a. The last sentence of paragraph .13 is replaced with:

For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

b. In paragraph .19, the word "competent" is replaced with the word "appropriate."

AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"

SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), as amended, is superseded.

AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"

SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), as amended, is amended as follows:

a. In the first sentence of paragraph .02, the word "competent" is replaced with the word "appropriate."

b. Footnote 3 to paragraph .04, is replaced with:

   Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, describes the procedures the auditor performs to obtain an understanding of internal control over financial reporting.

c. In the first sentence of paragraph .18, the word "competent" is replaced with the word "appropriate."

d. Within footnote 5 to paragraph .18, the reference to section 326, *Evidential Matter*, paragraph .19c. is replaced with a reference to paragraph 8 of Auditing Standard No. 15, *Audit Evidence*.

e. Within footnote 8 to paragraph .27, the reference to section 311, *Planning and Supervision*, paragraphs .11 through .14 is replaced with a reference to Auditing Standard No. 10, *Supervision of the Audit Engagement*.

AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations" (AU sec. 324, "Service Organizations"), as amended, is amended as follows:

a. In the first sentence of paragraph .07, the reference to Section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

b. In the first sentence of paragraph .16, the reference to section 319.90 through .99 is replaced with a reference to paragraph 18 and paragraphs 29 through 31 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

c. In the second sentence of paragraph .23, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit,* is replaced with a reference to Auditing Standard No. 14, *Evaluating Audit Results*.

AU sec. 326, "Evidential Matter"

SAS No. 31, "Evidential Matter" (AU sec. 326, "Evidential Matter"), as amended, is superseded.

AU sec. 9326, "Evidential Matter: Auditing Interpretations of Section 326"

AU sec. 9326, "Evidential Matter: Auditing Interpretations of Section 326," as amended, is amended as follows:

a. Paragraphs .01-.05 are deleted, along with the preceding heading "1. Evidential Matter for an Audit of Interim Financial Statements."

b. The reference in paragraph .10 to Section 326, *Evidential Matter*, paragraph .25, is replaced with a reference to Paragraph 35 of Auditing Standard No. 14, *Evaluating Audit Results*.

c. In the first and second sentences of paragraph .10, the word "competent" is replaced with the word "appropriate."

d. In the second sentence of paragraph .12, the word "competent" is replaced with the word "appropriate."

e. The last two sentences of paragraph .12 are deleted.

f. In the first sentence of paragraph .13, the word "competent" is replaced with the word "appropriate."

g. In paragraph .17, the word "competent" is replaced with the word "appropriate."

h. In the second sentence of paragraph .21, the word "competent" is replaced with the word "appropriate."

i. In the fourth sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."

j. In paragraph .23, the word "competent" is replaced with the word "appropriate."

k. Paragraphs .24-.41 are deleted, along with the headings "3. The Auditor's Consideration of the Completeness Assertion" and "4. Applying Auditing Procedures to Segment Disclosures in Financial Statements."

AU sec. 328, "Auditing Fair Value Measurements and Disclosures"

SAS No. 101, "Auditing Fair Value Measurements and Disclosures" (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), as amended, is amended as follows:

a. In the first sentence of paragraph .03, the word "competent" is replaced with the word "appropriate."

b. The phrase in paragraph .11 "Section 319, *Consideration of Internal Control in a Financial Statement Audit*, as amended," is replaced with "Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*,"

c. The reference in paragraph .14 to Section 319 is replaced with a reference to Paragraph A5, second note of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

d. In the second sentence of paragraph .14, the reference "(see section 316, *Consideration of Fraud in a Financial Statement Audit*" is deleted.

e. Within paragraph .25, in the second sentence of the second bullet point and in the first sentence in the third bullet point, the word "competent" is replaced with the word "appropriate."

f. In the second sentence of paragraph .32, the word "competent" is replaced with the word "appropriate."

g. In the first sentence of paragraph .42, the word "competent" is replaced with the word "appropriate."

h. In footnote 8 to paragraph .43, the reference to section 431, *Adequacy of Disclosure in Financial Statements,* is replaced with a reference to "paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results."*

i. In the second sentence of paragraph .44, the word "competent" is replaced with the word "appropriate."

j. The reference in paragraph .47 to section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraphs .36 through .41, is replaced with a reference to paragraphs 12 through 18 and 24 through 27 of Auditing Standard No. 14, *Evaluating Audit Results*.

AU sec. 329, "Analytical Procedures"

SAS No. 56, "Analytical Procedures" (AU sec. 329, "Analytical Procedures"), as amended, is amended as follows:

a. The title of the standard, "Analytical Procedures," is replaced with the title, "Substantive Analytical Procedures."

b. The text of paragraph .01 is replaced with:

This section establishes requirements regarding the use of substantive analytical procedures in an audit.

> Note: Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* establishes requirements regarding performing analytical procedures as a risk

assessment procedure in identifying and assessing risks of material misstatement.

Note: Auditing Standard No. 14, *Evaluating Audit Results,* establishes requirements regarding performing analytical procedures as part of the overall review stage of the audit.

c. The last sentence of paragraph .03 is deleted.

d. The text of paragraph .04 is replaced with:

Analytical procedures are used as a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions. In some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

e. Paragraphs .06-.08 and the preceding heading, "Analytical Procedures in Planning the Audit," are deleted.

f. At the end of paragraph .09, the following new sentence is added:

(See paragraph 11 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*)

g. Within footnote 1 to paragraph .09, the reference to section 326, *Evidential Matter,* is replaced with a reference to Auditing Standard No. 15, *Audit Evidence.*

h. Footnote 2 to paragraph .20 is deleted.

i. In paragraph .21:

- In the fourth sentence, the word "likely" is deleted.
- The reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, is replaced with a reference to Auditing Standard No. 14, *Evaluating Audit Results*.

j. Footnote 3 to paragraph .21 is deleted.

k. Paragraph .23 and the preceding heading, "Analytical Procedures Used in the Overall Review," and paragraph .24 and the preceding heading, "Effective Date," are deleted.

AU sec. 330, "The Confirmation Process"

SAS No. 67, "The Confirmation Process" (AU sec. 330, "The Confirmation Process"), is amended as follows:

a. The references in paragraph .02 to section 312, *Audit Risk and Materiality in Conducting an Audit*, and section 313, *Substantive Tests Prior to the Balance-Sheet Date*, are replaced with a reference to Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

b. The reference in paragraph .05 to Section 312 is replaced with a reference to Auditing Standard No. 8, *Audit Risk*.

c. The second sentence of paragraph .06 is replaced with:

   See paragraph 8 of Auditing Standard No. 15, *Audit Evidence*, which discusses the reliability of audit evidence.

d. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

e. In the third sentence of paragraph .11, the reference to Section 326 is replaced with a reference to Auditing Standard No. 15, *Audit Evidence*.

f. In the first sentence of paragraph .24, the word "competence" is replaced with the word "appropriateness."

g. In the last sentence of paragraph .27, the word "competent" is replaced with the word "appropriate."

AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"

SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investment in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), as amended, is amended as follows:

a. The reference in paragraph .01 to section 326, *Evidential Matter*, paragraphs .03 – .08, is replaced with a reference to paragraphs 11 and 12 of Auditing Standard No. 15, *Audit Evidence*.

b. Paragraph .06 is replaced with:

   Auditing Standard No. 9, *Audit Planning,* discusses the auditor's responsibilities for consideration of the use of persons with specialized skill or knowledge. Auditing Standard No. 10, *Supervision of the Audit Engagement,* discusses the auditor's responsibilities for supervision of specialists who are employed by the auditor. AU sec. 336, *Using the Work of a Specialist,* discusses the auditor's responsibilities for using the work of a specialist engaged by the auditor.

c. The first and second sentences of paragraph .07 are deleted. The third sentence is replaced with:

   The auditor should design and perform audit procedures regarding relevant assertions of derivatives and investments in securities that are based on and that address the risks of material misstatement in those assertions.

d. The reference in paragraph .09 to Section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

e. The fourth sentence of paragraph .11 is replaced with "Paragraphs 28 through 32 and B1 through B6 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* discuss the information system, including related business processes, relevant to financial reporting."

f. In paragraph .15, the reference to section 319 is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

g. The last sentence of paragraph .35 is replaced with:

In addition, paragraphs 24 through 27 of Auditing Standard No. 14, *Evaluating Audit Results*, describe the auditor's responsibilities for assessing bias in accounting estimates.

h. In paragraph .43, subparagraph a., the word "competent" is replaced with the word "appropriate."

i. In paragraph .51, the last sentence is replaced with:

(See paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.)*

j. In paragraph .57, subparagraph c., the word "competent" is replaced with the word "appropriate."

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows:

a. Footnote 4 to paragraph .06 is replaced with:

Auditing Standard No. 14, *Evaluating Audit Results*, indicates that a misstatement can arise from error or fraud and also discusses the auditor's responsibilities for evaluating accumulated misstatements.

b. Within footnote 6 to paragraph .06, the reference to Section 312 is replaced with a reference to Paragraph 11 of Auditing Standard No. 14, *Evaluating Audit Results*.

c. Within footnote 7 to paragraph .06, the reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, paragraphs .38 through .40, is replaced with a reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, paragraphs .79 through .82.

AU sec. 334, "Related Parties"

SAS No. 45, "Related Parties" (AU sec. 334 "Related Parties"), is amended as follows:

a. In the second sentence of paragraph .09, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

c. In footnote 8 to paragraph .11, the reference to section 431, *Adequacy of Disclosure in Financial Statements,* is replaced with a reference to paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.*

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334"

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334," is amended as follows:

Within footnote 4 to paragraph .17, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Auditing Standard No. 8, *Audit Risk*.

AU sec. 336, "Using the Work of a Specialist"

SAS No. 73, "Using the Work of a Specialist" (AU sec. 336, "Using the Work of a Specialist"), is amended as follows:

a. Footnote 1 to paragraph .01 is replaced with the following:

Because income taxes and information technology are specialized areas of accounting and auditing, this section does not apply to situations in which an income tax specialist or information technology specialist participates in the audit. Auditing Standard No. 10, *Supervision of the Audit Engagement,* applies in those situations.

b. Paragraph .05 is replaced with the following:

This section does not apply to situations in which a specialist employed by the auditor's firm participates in the audit. Auditing Standard No. 10, *Supervision of the Audit Engagement,* applies in those situations.

c. In the last sentence of paragraph .06, the word "competent" is replaced with the word "appropriate."

d. In the first and last sentences of paragraph .13, the word "competent" is replaced with the word "appropriate."

AU sec. 9336, "Using the Work of a Specialist: Auditing Interpretations of Section 336"

AU sec. 9336, "Using the Work of a Specialist: Auditing Interpretations of Section 336," is amended as follows:

a. In the second sentence of paragraph .04, the word "competent" is replaced with the word "appropriate."

b. In paragraph .05, the word "competent" is replaced with the word "appropriate."

c. In the second sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

d. The penultimate sentence of paragraph .15, is replaced with:

   Paragraph 6 of Auditing Standard No. 15, *Audit Evidence*, states, "[t]o be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based."

AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"

SAS No. 59, "The Auditor's Consideration of an Entity's Ability to Continue as Going Concern" (AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"), as amended, is amended as follows:

The reference in paragraph .02 to section 326, *Evidential Matter*, is replaced with a reference to Auditing Standard No. 15, *Audit Evidence*.

AU sec. 342, "Auditing Accounting Estimates"

SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), as amended, is amended as follows:

a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .07, the word "competent" is replaced with the word "appropriate."

c. The text of footnote 3 to paragraph .07 is replaced with:

See paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.*

d. The reference in paragraph .08 subparagraph b.1. to section 311, *Planning and Supervision*, is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

e. Paragraph .14, is replaced with:

Paragraphs 24 through 27 of Auditing Standard No. 14, *Evaluating Audit Results*, discuss the auditor's responsibilities for assessing bias and evaluating accounting estimates in relationship to the financial statements taken as a whole.

<u>AU sec. 9342, "Auditing Accounting Estimates: Auditing Interpretations of Section 342"</u>

AU sec. 9342, "Auditing Accounting Estimates: Auditing Interpretations of Section 342," is amended as follows:

In the second sentence of paragraph .02, the word "competent" is replaced with the word "appropriate."

<u>AU sec. 350, "Audit Sampling"</u>

SAS No. 39, "Audit Sampling" (AU sec. 350, "Audit Sampling"), as amended, is amended as follows:

a. Within footnote 2 to paragraph .02, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Auditing Standard No. 14, *Evaluating Audit Results*.

b. The last sentence of paragraph .03 is replaced with:

Either approach to audit sampling can provide sufficient evidential matter when applied properly. This section applies to both nonstatistical and statistical sampling.

c. Paragraph .04 is deleted.

d. In paragraph .06:

- The first sentence is deleted.

- In the last sentence, the word "competence" is replaced with the word "appropriateness."

- The following note is added to the paragraph:

  Note: Auditing Standard No. 15, *Audit Evidence*, discusses the appropriateness of audit evidence, and Auditing Standard No. 14, *Evaluating Audit Results,* discusses the auditor's responsibilities for evaluating the sufficiency and appropriateness of audit evidence.

e. Paragraph .08 is deleted.

f. In paragraph .09:

- The sentence in paragraph .09 referring to section 313, which is in parentheses, is deleted.

- The following note is added to the paragraph:

  Note: Auditing Standard No. 8, *Audit Risk,* describes audit risk and its components in a financial statement audit – the risk of material misstatement (consisting of inherent risk and control risk) and detection risk.

g. In paragraph .11:

- The phrase "(see section 311, *Planning and Supervision*)" is deleted.

- The sentence "(See section 313.)" is deleted.

h. The second sentence of paragraph .15 is replaced with:

See Auditing Standard No. 9, *Audit Planning*.

i. In the first bullet in paragraph .16, the phrase "(see section 326, *Evidential Matter*)" is deleted.

j. In the second bullet of paragraph .16, the phrase "Preliminary judgments about materiality levels" is replaced with the phrase "Tolerable misstatement. (See paragraphs .18-.18A.)"

k. Paragraph .18 is replaced with:

Evaluation in monetary terms of the results of a sample for a substantive test of details contributes directly to the auditor's purpose, since such an evaluation can be related to his or her judgment of the monetary amount of misstatements that would be material. When planning a sample for a substantive test of details, the auditor should consider how much monetary misstatement in the related account balance or class of transactions may exist, in combination with other misstatements, without causing the financial statements to be materially misstated. This maximum monetary misstatement for the account balance or class of transactions is called *tolerable misstatement*.

l. Paragraph .18A is added:

Paragraphs 8 - 9 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, describe the auditor's responsibilities for determining tolerable misstatement at the account or disclosure level. When the population to be sampled constitutes a portion of an account balance or transaction class, the auditor should determine tolerable misstatement for the population to be sampled for purposes of designing the sampling plan. Tolerable misstatement for the population to be sampled ordinarily should be less than tolerable misstatement for the account balance or transaction class to allow for the possibility that misstatement in the portion of the account or transaction class not subject to audit sampling, individually or in combination with other misstatements, would cause the financial statements to be materially misstated.

m. Paragraph .20 is deleted.

n. The first sentence of paragraph .21 is replaced with the following sentence:

The sufficiency of tests of details for a particular account balance or class of transactions is related to the individual importance of the items examined as well as to the potential for material misstatement.

o. Paragraph .23 is replaced with:

To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account tolerable misstatement for the population; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements.

p. Paragraph .23A is added:

Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

q. The last sentence of paragraph .25 is replaced with:

The auditor also should evaluate whether the reasons for his or her inability to examine the items have (a) implications in relation to his or her risk assessments (including the assessment of fraud risk), (b) implications regarding the integrity of management or employees, and (c) possible effects on other aspects of the audit.

r. Footnote 6 to paragraph .26 is replaced with:

Paragraphs 10 through 23 of Auditing Standard No. 14, *Evaluating Audit Results,* discuss the auditor's consideration of differences between the accounting records and the underlying facts and circumstances.

s. Within footnote 7 to paragraph .32, the phrase "(see section 319.85)" is deleted. In the first sentence of the footnote, the phrase "often plans" is replaced with the phrase "may plan." The last sentence of the footnote, which is in brackets, is deleted.

t. The last sentence of paragraph .38 is replaced with:

When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

u. The fifth sentence of paragraph .39 is replaced with:

Paragraphs 44 through 46 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, describe the auditor's responsibilities for performing procedures between the interim date of testing and period end.

v. In paragraph .39, the last sentence, which is in brackets, is deleted.

w. In paragraph .44:

- The first sentence is replaced with:

  In some circumstances, the auditor may design a sample that will be used for dual purposes: as a test of control and as a substantive test.

- The third sentence is replaced with:

  For example, an auditor designing a test of a control over entries in the voucher register may design a related substantive test at a risk level that is based on an expectation of reliance on the control.

- The fifth sentence is replaced with:

In evaluating such tests, deviations from the control that was tested and monetary misstatements should be evaluated separately using the risk levels applicable for the respective purposes.

- The following Note is added to the paragraph:

  Note: Paragraph 47 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, provides additional discussion of the auditor's responsibilities for performing dual-purpose tests.

x. The reference in paragraph .45 to paragraph .04 is changed to a reference to paragraph .03.

y. In item 2 of paragraph .48, the last sentence is deleted.

z. Within footnote 1 to item 4 in paragraph .48, the sentence "(See section 313.)" is deleted.

aa. The sentence in item 6 of paragraph .48 "(See section 313.)" is deleted.

AU sec. 9350, "Audit Sampling: Auditing Interpretations of Section 350"

AU sec. 9350, "Audit Sampling: Auditing Interpretations of Section 350," is superseded.

AU sec. 380, "Communication With Audit Committees"

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees"), as amended, is amended as follows:

In footnote 5 to paragraph .10, the reference to section 316A.38 -.40 is replaced with a reference to AU secs. 316.79 -.82; the reference to section 316A is replaced with a reference to section 316.

AU sec. 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles"

SAS No. 69, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles" (AU sec. 411, "The Meaning of Present Fairly in

Conformity with Generally Accepted Accounting Principles"), as amended, is amended as follows:

a. In paragraph .04, the reference in (c) to section 431 is replaced with a reference to paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*; in (d), the reference to section 431 is replaced with a reference to paragraph 31 of Auditing Standard No. 14.

b. The reference in footnote 1 to paragraph .04 to 312.10 is replaced with a reference to Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*.

AU sec. 431, "Adequacy of Disclosure in Financial Statements"

SAS No. 32, "Adequacy of Disclosure in Financial Statements" (AU sec. 431, "Adequacy of Disclosure in Financial Statements"), as amended, is superseded.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements" (AU sec. 508, "Reports on Audited Financial Statements"), as amended, is amended as follows:

a. In paragraph 18C, the phrase "and in AU sec. 431" is deleted.

b. In subparagraph .20.a., the word "competent" is replaced with the word "appropriate."

c. In the second sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."

d. In the third sentence of paragraph .24, the word "competent" is replaced with the word "appropriate."

e. In footnote 15 to paragraph .38, the first sentence is replaced with:

In this context, practicable means that the information is reasonably obtainable from management's accounts and records and that providing the information in the report does not require the auditor to assume the position of a preparer of financial information.

f. The references in paragraph .49 to section 312, *Audit Risk and Materiality,* and to section 342, *Auditing Accounting Estimates*, are replaced with a reference to paragraph 13 of Auditing Standard No. 14, *Evaluating Audit Results*.

g. In the first sentence of paragraph .63, the word "competent" is replaced with the word "appropriate."

h. In paragraph .66, the second sentence is replaced with:

(See paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.)*

AU sec. 9508, "Reports on Audited Financial Statements: Auditing Interpretations of Section 508"

AU sec. 9508, "Reports on Audited Financial Statements: Auditing Interpretations of Section 508," is amended as follows:

In paragraph .02, the word "competent" is replaced with the word "appropriate."

AU sec. 530, "Dating of the Independent Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 530, "Dating of the Independent Auditor's Report" (AU sec. 530, "Dating of the Independent Auditor's Report"), as amended, is amended as follows:

a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."

b. In the second note to paragraph .01, the word "competent" is replaced with the word "appropriate."

c. In the first sentence of paragraph .05, the word "competent" is replaced with the word "appropriate."

AU sec. 543, "Part of Audit Performed by Other Independent Auditors"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 543 "Part of Audit Performed by Other Independent Auditors" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), as amended, is amended as follows:

a. The following note is added as the second note to paragraph .01:

Note: For situations in which the auditor engages an accounting firm or individual accountants to participate in the audit engagement and AU sec. 543 does not apply, the auditor should supervise them in accordance with the requirements of Auditing Standard No. 10, *Supervision of the Audit Engagement*.

b. Within paragraph .12:

- Subparagraph b. is replaced with:

  A list of significant risks, the auditor's responses, and the results of the auditor's related procedures.

- Subparagraph f. is replaced with:

  A schedule of accumulated misstatements, including a description of the nature and cause of each accumulated misstatement, and an evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

<u>AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543"</u>

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543," as amended, is amended as follows:

a. <u>Paragraph .16 is replaced with:</u>

Interpretation − The principal auditor's response should ordinarily be made by the engagement partner. The engagement partner should take those steps that he or she considers reasonable under the circumstances to be informed of known matters pertinent to the other auditor's inquiry. For example, the engagement partner may inquire of engagement team members responsible for various aspects of the engagement or he or she may direct engagement team members to bring to his or her attention any significant matters of which they become aware during the audit. The principal auditor is not required to perform any procedures directed toward identifying matters that would not affect his or her audit or his or her report.

b. Footnote 4 to paragraph .16 is deleted.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

a. Within footnote 7 to paragraph .11, the first sentence is replaced with:

Paragraphs 10 through 23 of Auditing Standard No. 14, *Evaluating Audit Results*, require the auditor to accumulate and evaluate the misstatements identified during the audit.

b. The reference in paragraph .13 to section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

c. Within the last sentence of paragraph .16, the title of section 329, "Analytical Procedures," is replaced with the title "Substantive Analytical Procedures."

d. Footnote 20 to paragraph .26 is deleted.

e. The reference in paragraph .56, subparagraph C5, to section 319 is replaced with a reference to section 316.

Auditing Standard No. 3, *Audit Documentation*

Auditing Standard No. 3, *Audit Documentation*, as amended, is amended as follows:

a. Within paragraph 3, subparagraph b. is replaced with:

Supervisory personnel who review documentation prepared by other members of the engagement team.

b. Paragraph 9A is added:

Documentation of risk assessment procedures and responses to risks of misstatement should include (1) a summary of the identified risks of misstatement and the auditor's assessment of risks of material misstatement at the financial statement and assertion levels and (2) the auditor's responses to the risks of material misstatement, including linkage of the responses to those risks.

c. Within paragraph 12:

- Within subparagraph a.:, (1) a footnote reference 2A is added at the end of the first sentence:

  See paragraphs 12-13 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* and paragraphs .66-.67 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

  and (2) the second sentence of subparagraph a. is deleted.

- Subparagraph b. is replaced with:

  Results of auditing procedures that indicate a need for significant modification of planned auditing procedures, the existence of material misstatements (including omissions in the financial statements), and the existence of significant deficiencies or material weaknesses in internal control over financial reporting.

- Subparagraph c. is replaced with:

  Accumulated misstatements and evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

- Footnote 2B is added to subparagraph c.:

  See paragraphs 10-23 of Auditing Standard No. 14, *Evaluating Audit Results.*

- Subparagraph d. is replaced with:

  Disagreements among members of the engagement team or with others consulted on the engagement about final conclusions reached on significant accounting or auditing matters, including the basis for the final resolution of those disagreements. If an engagement team member disagrees with the final conclusions reached, he or she should document that disagreement.

- Subparagraph f. is replaced with:

  Significant changes in the auditor's risk assessments, including risks that were not identified previously, and the modifications to audit procedures or additional audit procedures performed in response to those changes.

- Footnote 2C is added to subparagraph f.:

  See paragraph 74 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, and paragraph 36 of Auditing Standard No. 14, *Evaluating Audit Results.*

- Subparagraph f-1. is added:

  Risks of material misstatement that are determined to be significant risks and the results of the auditing procedures performed in response to those risks.

d. Within paragraph 19:

- Subparagraph b. is replaced with:

  A list of significant risks, the auditor's responses, and the results of the auditor's related procedures.

- Subparagraph f. is replaced with:

  A schedule of accumulated misstatements, including a description of the nature and cause of each accumulated misstatement, and an evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

e. Paragraph 21 and the preceding heading, "Effective Date," are deleted.

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, as amended, is amended as follows:

In the first sentence of paragraph 18, the word "competent" is replaced with the word "appropriate."

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, is amended as follows:

a. In the second sentence of paragraph 3, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph 9, the phrase "any assistants" is replaced with the phrase "the engagement team members."

c. Within footnote 10 to paragraph 14, the reference to paragraphs .19-.42 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

d. The reference in paragraph 15 to AU sec. 316.44 and .45 is replaced with a reference to paragraphs 65-69 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

e. Within footnote 11 to paragraph 20, the reference to AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*.

f. Within footnote 12 to paragraph 28, the reference to AU sec. 326, *Evidential Matter*, is replaced with a reference to Auditing Standard No. 15, *Audit Evidence*.

g. Within footnote 13 to the note to paragraph 31, the reference to AU sec. 312.39 is replaced with a reference to paragraph 14 of Auditing Standard

No. 14, *Evaluating Auditing Results*. The reference to AU sec. 316.50 is replaced with a reference to paragraph 5 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

h. The references in paragraph 36 to paragraphs .16-.20, .30-.32, and .77-.79 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, are replaced with references to paragraph 29 and Appendix B of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

i. In the first sentence of paragraph 51, the word "competent" is replaced with the word "appropriate."

j. In the first sentence of paragraph 89, the word "competent" is replaced with the word "appropriate."

k. Within the note to paragraph C6 in Appendix C, the word "competent" is replaced with the word "appropriate."

Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*

Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, is amended as follows:

a. Footnote 3 to paragraph 4 is deleted.

b. In paragraph 10, the reference to AU sec. 431, *Adequacy of Disclosure in Financial Statements*, is replaced with a reference to paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.*

Auditing Standard No. 7, *Engagement Quality Review*

Auditing Standard No. 7, *Engagement Quality Review*, is amended as follows:

a. Footnote 3 to paragraph 5 is replaced with:

> The term "engagement partner" has the same meaning as the "practitioner-in-charge of an engagement" in PCAOB interim quality control standard QC sec. 40, *The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement*. QC sec. 40

describes the competencies required of a practitioner-in-charge of an attest engagement.

b. In paragraph 10, the note following subparagraph b. is replaced with:

Note: A *significant risk* is a risk of material misstatement that requires special audit consideration.

Ethics Standards

ET sec. 102, "Integrity and Objectivity"

ET sec. 102, "Integrity and Objectivity," is amended as follows:

Footnote 1 to paragraph .05 is replaced with:

See paragraph 5.b. of Auditing Standard No. 10, *Supervision of the Audit Engagement,* and paragraph 12.d. of Auditing Standard No. 3, *Audit Documentation*.

APPENDIX 10

Additional Discussion of Auditing Standards, Amendments to PCAOB Standards, and Comments on Reproposed Standards

This appendix discusses each of the auditing standards in Appendices 1-8 ("the risk assessment standards") and the related amendments to PCAOB standards in Appendix 9. In particular, this appendix provides additional background information for certain requirements in the standards. It discusses the Board's responses to comments on the standards reproposed on December 17, 2009 ("the reproposed standards"), including the basis for the Board's conclusions regarding certain requirements.

I. Discussion of Comments That Relate to Many of the Reproposed Standards

The following paragraphs discuss matters raised by commenters that relate to many of the reproposed standards. At the end of this appendix is a discussion of other topics raised by commenters on matters other than the risk assessment standards or the related amendments.

A. Consideration of Fraud in the Audit

Section I of the release discusses the Board's objectives regarding incorporating into its risk assessment standards the requirements for identifying and responding to risks of material misstatement due to fraud ("fraud risks") and evaluating audit results from AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*[1/]

The number of comments received on this approach to incorporate the requirements from AU sec. 316 declined significantly from the original proposed standards.[2/] The views of commenters continue to be mixed. One commenter supported the approach, and two commenters expressed concerns about the approach.

[1/] The risk assessment standards incorporate paragraphs .14-.51 and .68-.78 of AU sec. 316. Accordingly, those paragraphs are removed from AU sec. 316 by means of a related amendment. See Appendix 9.

[2/] As discussed in Section I of this release, the risk assessment standards were originally proposed on October 21, 2008. See PCAOB Release No. 2008-006, The risk assessment standards continue to include relevant requirements from AU sec. 316. The Board has observed from its oversight activities instances in which auditors have performed the procedures required in AU sec. 316 mechanically, without using the procedures to develop insights on fraud risk or to modify the audit plan to address that risk. The Board also has observed instances in which firms have failed to respond appropriately to identified fraud risks.

These observations suggest that some auditors may improperly view the consideration of fraud as an isolated, mechanical process rather than an integral part of audits under PCAOB standards. Integrating the requirements from AU sec. 316 into the risk assessment standards emphasizes to auditors that assessing and responding to fraud risks is an integral part of an audit in accordance with PCAOB standards, rather than a separate consideration. Such integration also should prompt auditors to make a more thoughtful and thorough assessment of the risks affecting the financial statements, including fraud risks, and to develop appropriate audit responses. Furthermore, AU sec. 316, as amended, will continue to provide relevant information on determining the necessary procedures for considering fraud in a financial statement audit. (See section X.F.2. of this appendix for more discussion about AU sec. 316.)

B. Organization and Style of Standards (Including the Use of Notes and Appendices)

In response to comments on the original proposed standards, the Board presented the reproposed standards using an organization and style that is intended to be a template for future standards of the Board. The organization and style includes an objective for each standard, which provides additional context for understanding the requirements in the standard, and a separate appendix for definitions of terms used in each standard.

Commenters generally supported the organization and style of the reproposed standards, and some commenters suggested that existing PCAOB standards be revised to implement this organization and style. As stated in the release accompanying the reproposed standards, the organization and style used in the reproposed standards draws from previously issued standards of the Board, e.g., Auditing Standard No. 7, *Engagement Quality Review.* Also, the Board will apply this template in the course of its other standards-setting activities.

Commenters expressed concerns about including requirements in appendices and notes to the standard. Consistent with standards previously issued by the Board, the notes and appendices in the risk assessment standards are integral parts of the standards and carry the same authoritative weight as the other portions of the standards.

C. Use of Terms

PCAOB Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, sets forth the terminology that the Board uses to describe the degree of responsibility that the auditing and related professional practice standards impose on auditors. The original proposed standards used terms in the requirements in a manner that was consistent with Rule 3101.

Some comments received on the original proposed standards suggested revisions to the terms used in the requirements or asked for clarification about certain terms or phrases, e.g., "take into account." The reproposed standards reflected numerous revisions to the terms used in the standards, and the risk assessment standards reflect further refinements. For example, the standards use "should consider" only when referring to a requirement to consider performing an action or procedure, which is consistent with Rule 3101.

As explained in the release accompanying the reproposed standards, the phrase "take into account" has been used previously in PCAOB standards in reference to information or matters that the auditor should think about or give attention to in performing an audit procedure or reaching a conclusion.[3/] Accordingly, the results of the auditor's thinking on the relevant matters should be reflected in the performance and documentation of the respective audit procedure performed or conclusion reached. The accompanying standards continue to use "take into account" in the same way.

Some commenters asked about the meaning of certain terms, e.g., "assess," "evaluate," or "determine." Those commenters also stated that the Board should use those terms consistently throughout its standards. The Board has reviewed the use of each of those terms and has revised the standards as necessary to apply those terms more consistently. Subsequent sections of this appendix discuss specific revisions to the individual standards.

[3/] AU sec. 316.45 and paragraphs 14, 44, 59, and B 12 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

One commenter expressed concerns about statements that involve the use of present tense in the reproposed standards. As with standards that the Board previously issued, the present tense is used in the risk assessment standards for statements that are factual or definitional, e.g., to provide additional explanation of a required auditing procedure.[4/] Subsequent sections of this appendix discuss specific instances of the use of present tense in the risk assessment standards.

D. Requirements and the Application of Judgment

Some commenters on the original proposed standards stated that the original proposed standards contained requirements that were "too prescriptive," limiting the auditor's ability to "use professional judgment or scale the audit," e.g., because of the number of requirements in the standards and because the standards did not explicitly refer to professional judgment in the requirements. In the release accompanying the reproposed standards, the Board discussed the importance of professional judgment in fulfilling the requirements of the standards. After examining each requirement, the Board revised certain provisions in the reproposed standards to streamline the presentation of those requirements.

Although the Board received fewer comments on the reproposed standard related to this topic, two commenters continue to express concerns about whether the reproposed standards made adequate allowance for the auditor to use professional judgment in assessing and responding to risk in an audit.

PCAOB standards recognize that the auditor uses judgment in planning and performing audit procedures and evaluating the evidence obtained from those procedures.[5/] As under other PCAOB standards, auditors need to exercise judgment in fulfilling the requirements of the risk assessment standards in the particular circumstances. Making references to judgment in selected portions of the standards, however, could be misinterpreted as indicating that judgment is required only in certain aspects of the audit. Instead of referring to judgment selectively, the risk assessment standards set forth principles for meeting the requirements of the standards and allow

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4/ See, e.g., paragraph 21 of Auditing Standard No. 5 for an example of the use of the present tense for this purpose.

5/ See, e.g., paragraph .11 of AU sec. 230, *Due Professional Care in the Performance of Work.*

the auditor to determine the most appropriate way to comply with the requirements in the circumstances.

II. Auditing Standard No. 8 – Audit Risk

A. Background

Auditing Standard No. 8 discusses audit risk and the relationships among the various components of audit risk in an audit of financial statements. The standard applies to integrated audits and to audits of financial statements only.

B. Objective

The reproposed standard stated that the objective of the auditor is to conduct the audit of financial statements in a manner that reduces audit risk to an appropriately low level. This objective provided important context for understanding how the concept of audit risk is applied in an audit.

One commenter observed that the reproposed standards sometimes used the phrase, "appropriately low level" and occasionally used the phrase "acceptably low level," and that commenter suggested revising the standards to use "acceptably low level" in each instance. The Board continues to believe the term "appropriately low level" is more suitable because it is aligned more closely with the degree of assurance described in the auditor's opinion, i.e., the auditor conducts the audit to reduce audit risk to an appropriately low level in order to express an opinion with reasonable assurance. In contrast, the term "acceptably low" is less clear and could be misinterpreted. The risk assessment standards have been revised to use the phrase "appropriately low level," as applicable.

C. Due Professional Care and Sufficient Appropriate Audit Evidence

The reproposed standard stated that, to form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. It also stated that reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.[6/]

[6/] Paragraph 3 of Auditing Standard No. 8.

A commenter suggested that due professional care is a responsibility throughout the audit, similar to professional skepticism and judgment, and need not be repeated throughout the Board's standards. The Board agrees that due professional care is a responsibility throughout the audit. On the other hand, existing PCAOB standards state that due professional care allows the auditor to obtain reasonable assurance,[7/] and the statement in Auditing Standard No. 8 acknowledges that principle.

D. Audit Risk and Risk of Material Misstatement

Some commenters on the original proposed standard requested more explanation about risks at the overall financial statement level, e.g., by providing examples of such risks. The reproposed standard elaborated further on risks at the financial statement level.[8/]

Commenters on the reproposed standard asked for more explanation regarding how financial statement level risks can result in material misstatement of the financial statements. The examples of financial statement level risks in Auditing Standard No. 8 have been expanded to illustrate how those risks can result in material misstatement of the financial statements.[9/]

Some individual commenters offered suggestions for refining or clarifying the discussion of the risk of material misstatement and its components. For example, one commenter suggested that the description of the risk of material misstatement should state that the risk exists "prior to the audit" to more clearly indicate that it is the company's risk. The Board agrees that the risk of material misstatement exists irrespective of the audit, while the risk of not detecting material misstatement is the auditor's risk. However, the suggested phrase could be misinterpreted, e.g., as implying that the auditor need not consider the risk of misstatements occurring during the audit.

The reproposed standard included a statement that inherent risk and control risk are the company's risks; they exist independently of the audit. One commenter suggested that the statement was not informative and suggested revising the standard to state that inherent risk and control risk are functions of the company's characteristics,

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[7/] AU sec. 230.10.

[8/] Paragraph 6 of Auditing Standard No. 8.

[9/] Ibid.

but influence the auditor's actions. The Board agrees that more discussion of the auditor's consideration of inherent risk and control risk is appropriate. Thus, Auditing Standard No. 8 has been expanded to discuss the sources of evidence the auditor uses when assessing inherent risk and control risk.[10/] Also, the description of control risk in Auditing Standard No. 8 has been aligned with the discussion of internal control concepts in Auditing Standard No. 5.

One commenter expressed a concern that descriptions of inherent risk, control risk, and detection risk that included the phrase "that could be material, individually or in combination with other misstatements," may be misinterpreted by the auditor as a requirement to consider whether the combination of dissimilar risks will result in a material misstatement. The commenter suggested changing "combination" to "aggregate." However, the standard does not discuss the combination of risks but, rather, the risk of a misstatement that could be material, individually or in combination with other misstatements, which is consistent with the description of the auditor's evaluation of uncorrected misstatements in Auditing Standard No. 14, *Evaluating Audit Results.* Thus, the term "combination" was retained as proposed.

E. Detection Risk

The reproposed standard indicated that detection risk is reduced by performing substantive procedures. Some commenters stated that the discussion of detection risk should be modified to indicate that auditors can reduce detection risk through procedures other than substantive procedures (e.g., risk assessment procedures and tests of controls). A commenter also suggested changing the sentence in the standard to refer to "audit procedures" instead of "substantive procedures."

The Board acknowledges that auditors might obtain evidence of misstatements through procedures other than substantive procedures. However, that does not diminish the auditor's responsibility to plan and perform substantive procedures for significant accounts and disclosures that are sufficient to provide reasonable assurance of detecting misstatements that would result in material misstatement of the financial statements. Changing "substantive procedures" to "audit procedures," as suggested by the commenter, is not consistent with AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit,* and could be misunderstood by auditors, resulting in

[10/] Paragraph 8 of Auditing Standard No. 8.

inadequate substantive procedures.[11/] To provide further clarification, Auditing Standard No. 8 has been revised to describe the role of risk assessment procedures and tests of controls in assessing the risk of material misstatement, which, in turn, affects the appropriate level of detection risk.[12/]

Some commenters expressed concerns that the reproposed standard did not adequately link the concepts of inherent risk and control risk to detection risk. They stated that a discussion on the relationship of these concepts is necessary for the auditor to determine the acceptable level of detection risk for the financial statement assertions, which, in turn, is used to determine the nature, timing, and extent of substantive procedures. The following discussion, which is adapted from AU sec. 319, was added to paragraph 10 of Auditing Standard No. 8: "The auditor uses the assessed risk of material misstatement to determine the appropriate level of detection risk for a financial statement assertion. The higher the risk of material misstatement, the lower the level of detection risk needs to be in order to reduce audit risk to an appropriately low level."[13/]

F. Integrated Audit Considerations

Auditing Standard No. 8 applies both to audits of financial statements only and to the financial statement audit portion of integrated audits. Audit risk in the audit of financial statements relates to whether the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, while audit risk in an audit of internal control over financial reporting ("audit of internal control") relates to whether the auditor expresses an inappropriate audit opinion when one or more material weaknesses exist. The two forms of audit risk are related, however, and Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* indicates that the risk assessment procedures apply to both the audit of financial statements and the audit of internal control.

[11/] AU secs. 319.81-.82. AU sec. 319, along with AU sec. 311, *Planning and Supervision*, AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date*, AU sec. 326, *Evidential Matter*, and AU sec. 431, *Adequacy of Disclosure in Financial Statements*, are superseded by the risk assessment standards.

[12/] Paragraphs 8-9 of Auditing Standard No. 8.

[13/] Paragraph 10 of Auditing Standard No. 8.

Some commenters suggested revisions to the first paragraph and the first footnote of the reproposed standard to clarify how the concepts of audit risk in this standard apply to audits of financial statements only and to integrated audits. The first paragraph has been revised to indicate that Auditing Standard No. 8 applies to either an audit of financial statements only or to an integrated audit. The first footnote also has been revised to clarify that, in integrated audits, the risks of material misstatement are the same for both the audit of financial statements and the audit of internal control.

III. <u>Auditing Standard No. 9 – Audit Planning</u>

A. Background

Auditing Standard No. 9 describes the auditor's responsibilities for planning an integrated audit or an audit of financial statements only.

B. Planning and Supervision

The original proposed standard and the reproposed standard discussed both audit planning and supervision, similar to AU sec. 311. Some commenters observed that audit planning and supervision should be covered in separate standards.

The Board agrees that audit planning and supervision of engagement team members are distinct activities that should be covered in separate standards. Accordingly, the Board has divided the requirements of the reproposed planning and supervision standard into separate standards. Dividing the requirements for planning and supervision into separate standards does not affect the auditor's responsibilities for planning the audit or supervising the work of engagement team members.

C. Responsibilities of the Engagement Partner

AU sec. 311 stated, "The auditor with final responsibility for the audit may delegate portions of the planning and supervision of the audit to other firm personnel." Auditing Standard No. 9 uses the term "engagement partner" instead of "auditor with final responsibility for the audit" and states more directly that the engagement partner is responsible for properly planning the audit. The standard also allows the engagement partner to seek assistance from appropriate engagement team members in fulfilling his or her planning responsibilities. Because the requirements in Auditing Standard No. 9 apply to the engagement partner and engagement team members who assist the engagement partner in planning the audit, the standard uses the term "auditor," and a footnote was added to clarify that the requirements in the standard apply to the engagement partner and other engagement team members who participate in planning the audit.

D. Preliminary Engagement Activities

The reproposed standard included a note in paragraph 6 stating that the decision regarding continuance of the client relationship and the determination of compliance with independence and ethics requirements were not limited to preliminary engagement activities and should be reevaluated with changes in circumstances. One commenter expressed concern that the note did not describe the changes in circumstances for which it would be appropriate for the auditor to reevaluate these decisions. The acceptance and continuance of the client relationship are discussed in QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice.* Other PCAOB standards discuss certain circumstances that warrant reevaluating the client relationship.[14/] Auditors also may reevaluate their engagement acceptance decision for other reasons. However, because auditors must comply with independence and ethics requirements throughout the audit, the note was moved in Auditing Standard No. 9 to modify paragraph 6.b. and revised to state that determination of compliance with independence and ethics requirements is not limited to preliminary engagement activities and should be reevaluated upon changes in circumstances.

E. Planning Activities

The reproposed standard stated that, as part of establishing the audit strategy and audit plan, the auditor should evaluate whether certain matters specified in the standard are important to the company's financial statements and internal control over financial reporting ("internal control") and, if so, how those matters would affect the auditor's procedures. The requirement in the reproposed standard was the same as in paragraph 9 of Auditing Standard No. 5, thus extending its application to an audit of financial statements.

Evaluation of the matters listed in paragraph 7 of Auditing Standard No. 9 can lead auditors to develop more effective audit strategies and audit plans. For example, evaluation of those matters can highlight areas that might warrant additional attention during the auditor's risk assessment procedures, which, in turn, could affect the audit procedures performed in response to the risks of material misstatement. Also, evaluation of the internal control related matters can help the auditor develop an

[14/] See, e.g., paragraphs .18-.21 of AU sec. 317, *Illegal Acts by Clients.*

appropriate audit strategy, e.g., in determining accounts for which reliance on controls might be appropriate in the audit of financial statements.

Some commenters suggested changes to the requirement, including deleting some of the matters discussed in the requirement, moving other matters elsewhere within the standard, or making specific revisions to the language of the standard. Also, some commenters suggested using "should consider" instead of "should evaluate."

The Board considered the suggested changes to the standard and determined that those changes would not substantially improve the standard. Also, it is important for the language in this requirement to be identical to the language in Auditing Standard No. 5 to emphasize that this required procedure is to be performed only once in an integrated audit, with the results of the procedure to be applied in planning both the financial statement audit and the audit of internal control. Also, reframing the requirement from "should evaluate" to "should consider" would weaken the requirement. Therefore, Auditing Standard No. 9 retains the wording from the reproposed standard.

F. Audit Strategy and Audit Plan

Auditing Standard No. 9 requires the auditor to take into account certain matters when establishing the overall audit strategy, including the reporting objectives of the engagement and the nature of the communications required by PCAOB standards; the factors that are significant in directing the activities of the engagement team; the results of preliminary engagement activities and the auditor's evaluation of certain important matters; and the nature, timing, and extent of resources necessary to perform the engagement.[15/] These matters generally relate to information that auditors obtain through other required procedures. One commenter suggested that this requirement should discuss the need for specialists. Auditing Standard No. 9 was revised to include a reference to paragraph 16 regarding the requirement for the auditor to determine whether specialized skill or knowledge is needed to perform the engagement.

The reproposed standard required the auditor to develop and document an audit plan that includes the planned nature, timing, and extent of the risk assessment procedures. One commenter suggested that it was unnecessary to document the timing of the risk assessment procedures because risk assessment is an ongoing process that occurs throughout the execution of the audit. Auditing Standard No. 9 retains the requirement to document the timing of the risk assessment procedures. Identifying and

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15/ Paragraph 9 of Auditing Standard No. 9.

appropriately assessing the risks of material misstatement provide a basis for designing and implementing responses to the risks of material misstatement, so the timing of the risk assessment procedures is important to determine the timing of other audit procedures.

The reproposed standard also required the auditor to develop and document the planned nature, timing, and extent of tests of controls and substantive procedures. One commenter suggested that the requirement should specify that the audit plan include planned tests at the "relevant assertion level." Auditing Standard No. 9 retains the requirement as reproposed. Audit procedures are not performed only at the assertion level, e.g., certain general audit procedures and tests of certain entity-level controls in the audit of internal control over financial reporting. Therefore, it is not appropriate to update the standard with the suggested language.

G. Requirements for Multi-location Engagements

Auditing Standard No. 9 establishes requirements that apply to audits of companies with operations in multiple locations or business units. Auditing Standard No. 9 requires the auditor to determine the extent to which audit procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual locations or business units. The auditor is required to assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit. Auditing Standard No. 9 also lists factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures. These requirements are risk-focused and aligned with the requirements in Auditing Standard No. 5.

An example was added to one of the factors in Auditing Standard No. 9 to highlight that the auditor's consideration of risks associated with a location or business unit includes whether significant unusual transactions are executed at that location or business unit, e.g., whether certain transactions were conducted at the location or business unit to achieve a particular accounting result. AU sec. 316 already requires the auditor to perform procedures regarding significant unusual transactions.

The reproposed standard included a statement¸ similar to Auditing Standard No. 5, that "The direction in paragraph 5 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement,* regarding incorporating an element of unpredictability in the auditing procedures means that the auditor should vary the nature, timing, and extent of audit procedures at locations or business units from year to year." Some commenters stated that the statement in the reproposed standard was unnecessarily prescriptive. After considering the comments received, the requirement regarding unpredictability was removed from the audit planning standard, and the requirements in Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, regarding incorporating an element of unpredictability were expanded to include discussion of varying the testing in the selected locations.[16/] However, this does not change the requirements in Auditing Standard No. 5 regarding incorporating unpredictability in testing controls at individual locations in audits of internal control.[17/]

The reproposed standard included a requirement for the auditor to determine the extent to which auditing procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatements. One commenter was concerned that the use of the term "consolidated financial statements" is inconsistent with the terminology used elsewhere in the standards and that the financial statements of companies with multiple divisions might not meet the definition of consolidated. The use of "consolidated financial statements" is consistent with the term used in Auditing Standard No. 5. The use of the term "consolidated" applies to situations in which the company has multiple locations or business units. Auditing Standard No. 9 retains the language as reproposed.

Some commenters requested clarification on how the requirements are expected to be applied in audits in which part of the work is performed by other auditors of financial statements of individual locations or business units that are included in the consolidated financial statements. A paragraph was added to Auditing Standard No. 9 to clarify that the auditor should apply the requirements in paragraphs 11-13 to determine the locations or business units for testing when the auditor plans to use the work and reports of other independent auditors who have audited the financial statements of one or more of the locations or business units (including subsidiaries,

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16/ Paragraph 5 of Auditing Standard No. 13.

17/ Paragraphs 61 and B13 of Auditing Standard No. 5.

divisions, branches, components, or investments) that are included in the consolidated financial statements. AU sec. 543, *Part of Audit Performed by Other Independent Auditors,* describes the auditor's responsibilities when the auditor uses the work and reports of other independent auditors.[18/]

H. Persons with Specialized Skill or Knowledge

Auditing Standard No. 9 indicates that the auditor should determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results. The responsibility has been extended from a similar requirement in AU sec. 311 regarding considering whether specialized information technology ("IT") skill or knowledge is needed in an audit. The requirement was extended to specialized skill or knowledge in areas besides IT, e.g., valuation specialists, actuarial specialists, income tax specialists, and forensic specialists, because of the prevalent use of such individuals by auditors.

The reproposed standard included a note that described the term "specialized skill or knowledge" as persons engaged or employed by the auditor who have specialized skill or knowledge. Some commenters suggested that this note be removed because paragraph 17 included a similar description. The note was removed from Auditing Standard No. 9 because it was unnecessary and redundant.

One commenter suggested revising the standard to require the auditor to consider using a fraud specialist. The suggested requirement to consider using a fraud specialist was not added to Auditing Standard No. 9 because the requirement in the reproposed standard already covers fraud specialists, and the types of specialized skill or knowledge that might be needed on a particular audit depend on the particular circumstances and the skill and knowledge of the engagement team.

Some commenters suggested that the requirements relating to the involvement of specialists be reframed as "assisting" the auditor. Such a formulation is too narrow to describe the range of involvement of specialists, which could include providing assistance to the auditor or actually performing audit procedures.

Paragraph 17 of Auditing Standard No. 9 describes the required level of knowledge of the subject matter in terms of the general types of procedures that the auditor should be able to perform with regard to the person with specialized skill or

[18/] Paragraph 14 of Auditing Standard No. 9.

knowledge. Paragraph 17, by itself, does not impose procedural requirements for working with persons with specialized skill or knowledge because those responsibilities already are described in either the supervision provisions of Auditing Standard No. 10, *Supervision of the Audit Engagement*, or AU sec. 336, *Using the Work of a Specialist*, as applicable.

IV. Auditing Standard No. 10 – Supervision of the Audit Engagement

A. Background

Auditing Standard No. 10 sets forth requirements for supervising the audit engagement, including supervising the work of engagement team members.

Auditing Standard No. 10 retains the basic requirements regarding supervision from AU sec. 311, with changes to align the requirements more closely with the other risk assessment standards. Auditing Standard No. 10 does not change the responsibilities for supervision from those in the supervision section of the reproposed standard on audit planning and supervision. However, the language in the standard has been revised in certain respects to describe more directly the supervisory responsibilities of the engagement partner and engagement team members who assist the engagement partner in supervision. As discussed later in this section, the Board has separate standards-setting projects regarding specialists and principal auditors, which will likely result in changes to the auditor's responsibilities regarding the auditor's use of specialists and use of other auditors, and, in turn, may result in changes to Auditing Standard No. 10.

B. Planning and Supervision

As discussed in section III.B., the original proposed standard and the reproposed standard included requirements for both audit planning and supervision, similar to AU sec. 311. Some commenters observed that audit planning and supervision should be covered in separate standards.

The Board agrees that audit planning and supervision of engagement team members are distinct activities that should be covered in separate standards. Accordingly, the Board has divided the requirements of the planning and supervision standard into separate standards. Dividing the requirements for planning and supervision into separate standards does not affect the auditor's responsibilities for planning the audit or supervising the work of engagement team members.

C. Objective

When the requirements for planning and supervision were divided into separate standards, the objective for supervision of the work of engagement team members was adapted from the elements of proper supervision in the reproposed standard. Auditing Standard No. 10 states, "The objective of the auditor is to supervise the audit engagement, including supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached." The revised objective does not alter the supervision responsibilities included in the original proposed standard or the reproposed standard.

D. Responsibilities of the Engagement Partner

AU sec. 311 stated, "The auditor with final responsibility for the audit may delegate portions of the planning and supervision of the audit to other firm personnel." Auditing Standard No. 10 uses the term "engagement partner" instead of "auditor with final responsibility for the audit."

Auditing Standard No. 10 states that the engagement partner is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for proper supervision of the work of engagement team members and for compliance with PCAOB standards, including standards regarding using the work of specialists,[19/] other auditors,[20/] internal auditors,[21/] and others who are involved in testing controls.[22/] As discussed previously, as the Board considers changes to the auditor's responsibilities regarding the auditor's use of specialists and use of other auditors, it also may consider changes to Auditing Standard No. 10.

Auditing Standard No. 10 allows the engagement partner to seek assistance from appropriate engagement team members in fulfilling his or her responsibilities pursuant to the standard. Engagement team members who assist the engagement partner in supervision should comply with the relevant requirements of Auditing Standard No. 10.

[19/] See Section IV.F. of this appendix.

[20/] Ibid.

[21/] AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.*

[22/] Paragraphs 16-19 of Auditing Standard No. 5.

The requirements in PCAOB standards for assignment of responsibilities to engagement team members also apply to assignments that involve assisting the engagement partner with his or her responsibilities pursuant to the standard.[23/]

E. Supervision of the Work of Engagement Team Members

Previously adopted PCAOB standards use either the term "engagement team members" or the term "assistants." Auditing Standard No. 10 uses "engagement team members," which is consistent with the other risk assessment standards. The Board is amending other PCAOB standards to conform to this terminology.

Auditing Standard No. 10 describes the required supervisory activities that should be performed by the engagement partner and, as applicable, by other engagement team members with supervisory responsibilities.[24/] Those activities include informing engagement team members of their responsibilities and information relevant to those responsibilities, directing engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities, and reviewing the work of engagement team members as described in the standard.

Auditing Standard No. 10 describes the factors that should be taken into account in determining the necessary extent of supervision, i.e., the extent of supervision necessary so that the work of engagement team members is performed as directed and appropriate conclusions are formed based on the results of their work.[25/] Factors that affect the necessary extent of supervision include the risks of material misstatement, the nature of work assigned to the engagement team member, and the nature of the company, which includes the organizational structure of the company and its size and complexity. The extent of supervision of the work of an individual engagement team member increases or decreases, but cannot be eliminated, based on those factors. For example, the extent of supervision should be commensurate with the risks of material

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[23/] See, e.g. AU sec. 230.06 and paragraph 5 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

[24/] Paragraph 5 of Auditing Standard No. 10.

[25/] Paragraph 6 of Auditing Standard No. 10.

misstatement, which means, among other things, that the higher risk areas of the audit require more supervisory attention from the engagement partner.

One commenter suggested that the standard provide examples of "levels of supervision in relation to review," such as face-to-face review when reviewing higher risk areas. Auditing Standard No. 10 does not prescribe a particular method of review, so the engagement partner can determine the most effective way to comply with the requirements regarding the necessary nature of supervisory activities and necessary extent of supervision.

F. Persons with Specialized Skill or Knowledge and Other Auditors, Accounting Firms, and Individual Accountants

Auditing Standard No. 10 states that the engagement partner is responsible for, among other things, compliance with PCAOB standards regarding using of the work of specialists and refers to AU sec. 336. AU sec. 336 applies to situations in which the auditor engages a specialist in an area other than accounting or auditing and uses the work of that specialist as audit evidence.[26/] Paragraphs 5-6 of Auditing Standard No. 10 describe the nature and extent of the supervisory activities necessary for proper supervision of a person with specialized skill or knowledge who participates in the audit and is either (a) employed by the auditor or (b) engaged by the auditor to provide services in a specialized area of accounting or auditing. AU sec. 336 has been amended to clarify when the auditor should look to the supervisory requirements in Auditing Standard No. 10 instead of AU sec. 336.

AU sec. 543 describes the principal auditor's[27/] responsibilities for using the work and reports of other independent auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented. The principal auditor should look to the

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[26/] AU sec. 336 also applies to situations in which the auditor uses the work of a specialist engaged or employed by management. The discussion in this section of the release focuses on the auditor's use of specialists who are employed or engaged by the auditor.

[27/] AU sec. 543 uses the term "principal auditor" to refer to the auditor who issues the audit report on the financial statements presented.

requirements in AU sec. 543[28/] in those situations. For situations in which the auditor engages an accounting firm or individual accountants to participate in the audit engagement and AU sec. 543 does not apply,[29/] the auditor should supervise them in accordance with the requirements of Auditing Standard No. 10. AU sec. 543 has been amended to emphasize those points.

It should be noted, however, that the Board has separate standards-setting projects regarding specialists and principal auditors, which will include comprehensive reviews of AU sec. 336 and AU sec. 543, respectively, in light of, among other things, observations from the Board's inspection activities. Those projects will likely result in changes to the auditor's responsibilities regarding the auditor's use of specialists and use of other auditors, and, in turn, may result in changes to Auditing Standard No. 10.

G. Differences of Opinion within an Engagement Team

The original proposed standard included a requirement, adapted from AU sec. 311.14, that the engagement partner and other engagement team members should make themselves aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among the engagement team members. Since the intention of including this provision was to require adequate documentation of disagreements, this paragraph was removed from the reproposed standard, and the documentation requirements from the original proposed standard were incorporated into an amendment to Auditing Standard No. 3, *Audit Documentation*.[30/] The documentation requirements regarding disagreements among members of the engagement team or with others consulted on the engagement about final conclusions reached on significant accounting or auditing matters include documenting the basis for the final resolution of those disagreements. If an engagement team member disagrees with the final conclusions reached, he or she should document that disagreement.

One commenter indicated concern that the requirement for the engagement partner and other engagement team members to be aware of how disagreements

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[28/] For integrated audits, see also paragraphs C8-C11 of Auditing Standard No. 5.

[29/] Examples of situations that are not covered by AU sec. 543 include loan staff arrangements.

[30/] Paragraph 12.d. of Auditing Standard No. 3.

should be handled has been removed. The commenter indicated that disagreements are a sensitive area and that it is important that engagement team members are aware of how disagreements should be handled. In connection with the requirement to direct engagement team members to bring significant accounting and auditing issues to the attention of the engagement partner or other engagement team members performing supervisory activities, Auditing Standard No. 10 also states that each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or the auditor's report regardless of how those disagreements or concerns may have arisen.[31/]

V. Auditing Standard No. 11 – Consideration of Materiality in Planning and Performing an Audit

A. Background

Auditing Standard No. 11 discusses the auditor's responsibilities for applying the concept of materiality, as described by the courts in interpreting the federal securities laws, in planning the audit and determining the scope of the audit procedures. The standard applies to integrated audits and audits of financial statements only.

B. Materiality in the Context of an Audit

Auditing Standard No. 11 discusses the concept of materiality that is applicable to audits performed in accordance with PCAOB standards, which is the articulation of materiality used by the courts in interpreting the federal securities laws.[32/] The Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[33/]

Some commenters questioned the use of the court's articulation in the reproposed standard and suggested that this articulation might be difficult for auditors to

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31/ Note to paragraph 5.b. of Auditing Standard No. 10.

32/ Paragraph 2 of Auditing Standard No. 11.

33/ See TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

apply. Also, some commenters asked whether the use of this articulation of materiality, in contrast to the quotation from a FASB Concept Statement[34/] used in AU sec. 312 was intended to result in a change in audit practice.

Although the discussion of materiality in the accounting literature might help auditors understand how accounting standards-setters view materiality in the context of preparation and presentation of financial statements, the concept of materiality that is relevant for audits to which PCAOB standards apply is the concept used by the courts in interpreting the federal securities laws. Because the auditor has a responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements, it is important for the auditor to plan and perform his or her audit procedures based on the applicable concept of materiality. Accordingly, Auditing Standard No. 11 uses the concept of materiality articulated by the courts.

Because the courts' articulation of the concept of materiality is not new, using that articulation in Auditing Standard No. 11 is not intended to result in changes in practice for most auditors. Auditing Standard No. 11 emphasizes that an auditor's consideration of materiality should reflect matters that would affect the judgment of a reasonable investor.

C. Establishing a Materiality Level for the Financial Statements as a Whole

Auditing Standard No. 11 requires the auditor to establish an appropriate materiality level for the financial statements as a whole.[35/] This materiality level should be established in light of the particular circumstances based on factors that could influence the judgment of a reasonable investor. The standard states that this requirement includes consideration of the company's earnings and other relevant factors. This statement is intended to emphasize that a company's net earnings are often an important factor in the total mix of information available to a reasonable investor, but Auditing Standard No. 11 does not require the use of earnings as the basis for the established materiality level in all cases. Other factors besides earnings might be more relevant depending on the particular circumstances, e.g., based on a company's

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34/ Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information.* FASB Concepts Statements are not included in FASB's Codification of Accounting Standards.

35/ Paragraph 6 of Auditing Standard No. 11.

industry or situations in which the company's earnings were near zero. Auditors are expected to consider the factors that would be relevant to the judgment of a reasonable investor.

D. Qualitative Considerations

The concept of materiality involves consideration of both quantitative and qualitative factors.[36/] Under Auditing Standard No. 11, qualitative considerations can affect the auditor's establishment of materiality levels in the following ways:

- Establishing a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This involves matters such as consideration of the elements of the financial statements that are more important to a reasonable investor and the level of misstatements that would influence the judgment of a reasonable investor.

- Establishing lower levels of materiality for certain accounts or disclosures when, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. The requirement in the standard[37/] is consistent with the principle of considering the judgment of a reasonable investor when establishing materiality levels because it recognizes that, in certain circumstances, misstatements in some accounts might have more significant consequences than in other accounts. The following are examples of such circumstances:

    o Laws, regulations, or the applicable financial reporting framework affect investors' expectations about the measurement or disclosure of certain items, e.g., related party transactions and compensation of senior management.

[36/] Paragraph 3 of Auditing Standard No. 11.

[37/] Paragraph 7 of Auditing Standard No. 11.

- o Significant attention has been focused on a particular aspect of a company's business that is separately disclosed in the financial statements, e.g., a recent business acquisition.
- o Certain disclosures are particularly important to investors in the industry in which the company operates.

Auditing Standard No. 11 does not allow the auditor to establish a materiality level for an account or disclosure at an amount that exceeds the materiality level for the financial statements as a whole.

The reproposed standard included a statement, adapted from AU sec. 312, that ordinarily it is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors.[38/] One commenter suggested removing the word "ordinarily" from the statement because, in the commenter's view, it is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors. Auditing Standard No. 11 retains the statement as proposed. This statement reflects the principle that judgments about whether a particular misstatement is material involve consideration of the particular circumstances, including the nature of the misstatement and its effect on the financial statements. Also, if an auditor is aware of potential misstatements that would be material based on qualitative factors, he or she has a responsibility to design audit procedures to detect such misstatements.

E. Tolerable Misstatement

The reproposed standard required the auditor to determine tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level.[39/] Tolerable misstatement is a concept used in determining the scope of audit procedures. AU sec. 350, *Audit Sampling*, indicates that tolerable misstatement is the maximum amount of misstatement in an account or a class of transactions that may exist without causing the financial statements to be materially misstated.[40/] Tolerable misstatement is required to be set at an amount less than the materiality level for the financial statements as a

38/ AU sec. 312.20.

39/ Paragraphs 8-9 of Auditing Standard No. 11.

40/ AU sec. 350.18.

whole and for particular accounts or disclosures, if lower materiality levels were established for particular accounts or disclosures.

Some commenters suggested replacing the term "tolerable misstatement" in the reproposed standard with the term "performance materiality," which is the term used in the International Standards on Auditing ("ISAs").

The Board decided to retain the term "tolerable misstatement" in its standards. The concept of tolerable misstatement is already understood by auditors, and the Board is not seeking to change the concept as described in PCAOB standards. Because the term "performance materiality" uses the word "materiality," it could be misunderstood, e.g., by nonauditors, as having a meaning other than that intended in the standard. The concept of materiality that applies to financial statements of companies that are audited in accordance with PCAOB standards is rooted in case law and reflects a reasonable investor's perspective. In contrast, tolerable misstatement is a concept used in audit scoping decisions at the account level, considering potential uncorrected and undetected misstatement.

One commenter stated that the requirement to establish tolerable misstatement eliminated the need to establish a lower level of materiality for particular accounts or disclosures. However, the two concepts are designed for different purposes. The requirement to establish a lower materiality level is intended to address the need for a lower threshold when, in light of the particular circumstances, misstatements of lesser amounts have a substantial likelihood of influencing the judgment of a reasonable investor. As mentioned previously, tolerable misstatement is a concept used in audit scoping decisions at the account level, considering potential uncorrected and undetected misstatement.

The reproposed standard also required the auditor to take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of financial statements of prior periods. One commenter suggested that the Board should clarify its intent regarding this requirement and provide additional guidance regarding its application. Tolerable misstatement is affected by the expected level of misstatement in the account or disclosure, and the nature, cause, and amount of misstatements from prior periods are relevant to developing expectations about the level of misstatement. Generally, as the expected level of misstatement increases, the amount of tolerable misstatement decreases.

F. Consideration of Materiality for Multi-location Engagements

The reproposed standard included requirements for establishing materiality levels in multi-location engagements. The reproposed standard stated that when the auditor plans to perform procedures at selected locations or business units, the auditor should establish the materiality level for the individual locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements. The reproposed standard also stated that the materiality level for the selected locations or business units generally should be lower than the materiality level for the consolidated financial statements. Those requirements were an application of the fundamental principles to audits of consolidated financial statements of companies with multiple locations or business units.

Some commenters suggested removing the word "generally" as it could be misinterpreted as permitting the use of the materiality level for the consolidated financial statements as a whole for planning and performing audit procedures at the individual location or business unit level. Other commenters questioned how the requirements would be applied when a principal auditor makes reference to the report of another auditor in the auditor's report on consolidated financial statements in accordance with AU sec. 543.

After considering the comments, the Board has made certain clarifying revisions to the requirements for multi-location engagements.[41/] First, the language in the standard has been revised to use term "tolerable misstatement" for an individual location to more clearly distinguish that term from the materiality level for the financial statements as a whole. In addition, the requirements were revised to state that tolerable misstatement for a location or business unit should be less than the materiality level for the financial statements as a whole. The word "generally" was removed from the requirements to reduce the risk of misinterpretation of the provision. Also, the phrase "to be used in performing audit procedures" has been removed from the requirement to determine tolerable misstatement for the individual locations or business units to avoid a misinterpretation about the principal auditor's responsibilities for situations in which the principal auditor makes reference to the report of the other auditor in accordance with AU sec. 543. Auditing Standard No. 11 requires the principal auditor to determine tolerable misstatement for the location or business unit audited by the other auditor, but the principal auditor is not expected to impose that determination of tolerable

41/ Paragraph 10 of Auditing Standard No. 11.

misstatement on the other auditor. Rather, tolerable misstatement for the location or business unit audited by the other auditor would be relevant to certain requirements under AU sec. 543 [42/] and in determining an appropriate amount of tolerable misstatement for the remaining locations or business units included in the consolidated financial statements.

G. Reevaluating the Materiality Level and Tolerable Misstatement

The reproposed standard stated that the established materiality level and tolerable misstatement should be reevaluated if changes in the particular circumstances or additional information comes to the auditor's attention that are likely to influence the judgment of a reasonable investor. In addition, the reproposed standard provided examples of situations that would require such reevaluation, and additional examples were discussed in the release accompanying the reproposed standards.

Some commenters suggested that the examples in the release should be included in the reproposed standard. The examples in Auditing Standard No. 11 have been revised to clarify the types of situations that would require reevaluation of the established materiality level and tolerable misstatement.

The reevaluation required by Auditing Standard No. 11 is important because if that reevaluation results in a lower materiality level or levels and tolerable misstatement than the auditor's initial determination, the standard states that the auditor should (1) evaluate the effect, if any, of the lower amount or amounts on his or her risk assessments and audit procedures and (2) modify the nature, timing, and extent of audit procedures as necessary to obtain sufficient appropriate audit evidence.[43/]

Auditing Standard No. 11 does not allow the auditor to modify the established level or levels of materiality and tolerable misstatement solely because they are approximately equal to or are exceeded by the amount of uncorrected misstatements. Such a practice is inconsistent with the requirement to reevaluate the established materiality level or levels or tolerable misstatement if changes in the particular

[42/] For example, AU sec. 543.10 states that the auditor should adopt measures to assure the coordination of the principal auditor's activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements.

[43/] Paragraph 12 of Auditing Standard No. 11.

circumstances or additional information come to the auditor's attention that are likely to affect the judgments of a reasonable investor. Rather, Auditing Standard No. 14 establishes requirements for evaluating uncorrected misstatements[44/] and describes the auditor's responsibilities in situations in which uncorrected misstatements approach established materiality level or levels used in planning and performing an audit.[45/]

VI. Auditing Standard No. 12 – Identifying and Assessing Risks of Material Misstatement

A. Background

Auditing Standard No. 12 describes the auditor's responsibilities for the process of identifying and assessing risks of material misstatement in an audit of financial statements only and in an integrated audit. This process includes (1) performing information-gathering procedures, known as risk assessment procedures, and (2) identifying and assessing the risks of material misstatement using information obtained from the risk assessment procedures.

As discussed in the release accompanying the reproposed standards, the requirements in this standard are intended to improve the auditor's risk assessments and ability to focus on areas of increased risk in audits of financial statements only and in integrated audits. The effectiveness of a risk-based audit depends on whether the auditor identifies the risks of material misstatement and has an appropriate basis for assessing those risks. Inappropriate identification or assessment of risks of material misstatements can lead to overlooking relevant risks to the financial statements, e.g., business conditions that affect asset quality or create pressures to manipulate the financial statements, or assessing risks too low without having an appropriate basis for the assessment. In turn, these situations can lead to misdirected or inadequate audit work.

Auditing Standard No. 12 employs a top-down approach to risk assessment. Such an approach begins at the financial statement level and with the auditor's overall understanding of the company and its environment and works down to the significant accounts and disclosures and their relevant assertions. Also, the requirements for

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44/ Paragraphs 17-23 of Auditing Standard No. 14.

45/ Paragraph 14.b. of Auditing Standard No. 14.

performing risk assessment procedures are designed to be scalable to companies of varying size and complexity.

In an integrated audit, the risks of material misstatement affect both the audit of financial statements and the audit of internal control, so the risk assessment process described in Auditing Standard No. 12 is for a single process that applies to both the audit of financial statements and the audit of internal control. Auditing Standard No. 12 seeks to enhance the integration of the audit of financial statements with the audit of internal control by aligning these risk assessment standards with Auditing Standard No. 5. Accordingly, Auditing Standard No. 12 reflects certain foundational risk assessment principles from Auditing Standard No. 5 that also apply to audits of financial statements. On the other hand, the provisions of this standard also are designed to be tailored for audits of financial statements only, e.g., the requirements relating to the understanding of internal control over financial reporting.

B. Objective

Some commenters recommended that the Board revise the objective in the reproposed standard to indicate that the auditor's identification and assessment of risks are through understanding of the company and its environment. The objective in Auditing Standard No. 12 was retained from the reproposed standard. The revision suggested by the commenters is too narrow because Auditing Standard No. 12 requires other risk assessment procedures beyond obtaining an understanding of the company and its environment.

C. Performing Risk Assessment Procedures

The overarching requirement for risk assessment procedures in Auditing Standard No. 12 is that the auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of the risks of material misstatement, whether due to error or fraud, and to design further audit procedures.[46/] Auditing Standard No. 12 discusses the auditor's responsibilities for determining and performing the risk assessment procedures necessary to satisfy that overarching requirement.[47/]

[46/] Paragraph 4 of Auditing Standard No. 12. The phrase "design further audit procedures" applies to substantive procedures and to tests of controls in the audit of financial statements and the audit of internal control over financial reporting.

[47/] Paragraphs 5-58 of Auditing Standard No. 12.

Risks of material misstatement may exist at the financial statement level or at the assertion level. Risks of material misstatement also can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. Since the risks of material misstatement come from various sources, the auditor's risk assessment procedures need to encompass both external factors and company-specific factors. Auditing Standard No. 12 requires the following risk assessment procedures:

- Obtaining an understanding of the company and its environment;[48/]
- Obtaining an understanding of the company's internal control over financial reporting;[49/]
- Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company;[50/]
- Performing analytical procedures;[51/]
- Conducting a discussion among engagement team members regarding the risks of material misstatement;[52/] and
- Inquiring of the audit committee, management, and others within the company about the risks of material misstatement.[53/]

The reproposed standard required the auditor to perform risk assessment procedures that are designed to help the auditor identify the areas of greater risk,

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48/ Paragraphs 7-17 of Auditing Standard No. 12.

49/ Paragraphs 18-40 of Auditing Standard No. 12.

50/ Paragraphs 41-45 of Auditing Standard No. 12.

51/ Paragraphs 46-48 of Auditing Standard No. 12.

52/ Paragraphs 49-53 of Auditing Standard No. 12.

53/ Paragraphs 54-58 of Auditing Standard No. 12.

appropriately assess those risks, and design and perform further audit procedures to address risks of material misstatements in the financial statements, whether due to error or fraud. One commenter suggested adding the phrase "and to design further audit procedures focused on the areas of greatest risk" to the end of the sentence in paragraph 4. The suggested language is not included in Auditing Standard No. 12 because that principle is already addressed in Auditing Standard No. 13.

One commenter on the reproposed standard asked for more discussion of the connection between the components of audit risk and the risk assessment process. That discussion has been added to Auditing Standard No. 8.[54/]

D. Obtaining an Understanding of the Company and its Environment

Like the reproposed standard, Auditing Standard No. 12 requires the auditor to obtain an understanding of the company and its environment to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement ("obtaining an understanding of the company").[55/] These requirements are an expansion of requirements that were in AU sec. 311 regarding obtaining knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics as part of audit planning.[56/] The expanded requirements are intended to focus the auditor on the degree of "knowledge of the company" that is necessary for a risk-based audit and to explain how knowledge of the company informs the auditor's identification and assessment of risk.

Auditing Standard No. 12 requires that the understanding of the company and its environment include understanding the following:

- Relevant industry, regulatory, and other external factors;
- The nature of the company;
- The company's selection and application of accounting principles, including related disclosures;

54/ Paragraphs 8-11 of Auditing Standard No. 8.

55/ Paragraph 7 of Auditing Standard No. 12.

56/ AU secs. 311.06-.09.

- The company's objectives and strategies and those related business risks that might reasonably be expected to result in risks of material misstatement; and

- The company's measurement and analysis of its financial performance.[57/]

Auditing Standard No. 12 requires the auditor to evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.[58/] This requirement builds on the requirement in paragraph 7 of Auditing Standard No. 9 to evaluate whether, among other things, the extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting is important to the company's financial statements and internal control over financial reporting and, if so, how those changes will affect the auditor's procedures. PCAOB standards have recognized that many risks of material misstatement arise due to changes in the company. For example, AU sec. 319 listed the following examples of circumstances that can result in risks or changes to existing risks: changes in operating environment; new personnel; new or revamped information systems; rapid growth; new technology; new business models, products, or activities; corporate restructurings; expanded foreign operations; and new accounting pronouncements.[59/]

Paragraphs 9-17 of Auditing Standard No. 12 explain more fully the necessary understanding of the preceding aspects of the company and its environment, e.g., what it means to obtain an understanding of the nature of the company. The discussion of relevant industry, regulatory, and other external factors is adapted from AU sec. 311. The discussion of the nature of the company is also adapted from AU sec. 311 and has been updated to reflect certain changes in business practices since AU sec. 311 was originally issued (e.g., to encompass alternative investments and financing arrangements and to recognize the development of new business models).

One commenter said that the requirement to obtain an understanding of the company and its environment should be revised because none of the aspects of the company and its environment listed in paragraph 7 is an event, condition, or company

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57/ Paragraph 7 of Auditing Standard No. 12.

58/ Paragraph 8 of Auditing Standard No. 12.

59/ AU sec. 319.38.

activity. However, the understanding of those aspects should lead the auditor to obtain an understanding of relevant events, conditions, and company activities. For example, obtaining an understanding of relevant industry, regulatory, and external factors helps an auditor understand the external conditions in which the company operates that represent risks of material misstatement at the financial statement level.

The reproposed standard contained a note about how the size and complexity of the company can affect the risks of misstatement and the controls necessary to address those risks. This note was intended to be a reminder to auditors that both size and complexity affect risks. One commenter stated that complexity rather than size is likely to heighten risk. Auditing Standard No. 12 retains the note as reproposed.[60/] The size and complexity of the company can affect the risks of misstatement and the controls necessary to address those risks. Scaling the audit is most effective as a natural extension of the risk-based approach and applies to all audits, and the requirements in Auditing Standard No. 12 are intended to be scalable to companies of varying size and complexity. Auditing Standard No. 12 contains certain notes regarding scaling the audit based on a company's size and complexity.

1. Additional Procedures to Obtain an Understanding of the Company and its Environment

The reproposed standard presented a list of procedures that the auditor should consider performing as part of obtaining an understanding of the company and its environment. These procedures include reading public information about the company, observing or reading transcripts of earnings calls, obtaining an understanding of compensation arrangements with senior management, and obtaining information about significant unusual developments regarding trading activity in the company's securities. The auditor's decisions about whether to perform one or more of the additional procedures and the extent of those procedures depend on whether the matters addressed in those procedures are important to the company's internal control or financial statements and whether such procedures are necessary to meet the overall requirements for obtaining an understanding of the company and performing risk assessment procedures.

Members of the Board's Standing Advisory Group ("SAG") suggested that these matters could provide valuable information for identifying risks of material misstatement, e.g., to obtain information about business risks relevant to financial reporting or to

60/ First note to paragraph 10 of Auditing Standard No. 12.

identify incentives or pressures on management to manipulate financial results.[61] Also, the Public Oversight Board, *Panel on Audit Effectiveness, Report and Recommendations* ("*PAE Report*"), recommended that auditors consider published analysts' reports and forecasts when gaining an understanding of the company's business and industry, assessing risks, and evaluating identified misstatements.[62]

Commenters requested clarification of the Board's expectations regarding these procedures and expressed concern that the broad language used to describe some of the procedures might lead auditors to expend considerable efforts to decide and document whether to perform certain procedures. This requirement is not intended to require auditors to make a specific determination about each bit of data to which a procedure might be applied, e.g., to document each individual item of publicly available information to decide whether it should be reviewed.

Instead, the intention is for auditors to consider whether and to what extent such procedures should be performed to achieve the objectives in paragraphs 4 and 7 of Auditing Standard No. 12. For example, observing the company's earnings calls and other meetings with investors are likely to provide important information about the measurement and review of the company's financial performance, particularly the performance measures monitored by investors and analysts. Likewise, an understanding of compensation arrangements with senior management often can provide important information about incentives or pressures on management to manipulate the financial statements.

Auditing Standard No. 12 was revised to clarify that considering whether to perform the procedures listed in paragraph 11 also includes consideration of the extent of the procedures.

2. Selection and Application of Accounting Principles, Including Related Disclosures

PCAOB standards require auditors to obtain an understanding of the accounting practices common to the industry and to evaluate the quality of a company's accounting principles as part of his or her response to fraud risks and in determining matters to be

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[61] February 16, 2005. Webcasts of SAG meetings are available on the Board's website at: http://www.pcaobus.org/News_and_Events/Webcasts.

[62] Public Oversight Board, *Panel on Audit Effectiveness, Report and Recommendations* (August 31, 2000), p. 58.

communicated to the audit committee.[63] Auditing Standard No. 12 imposes a responsibility to obtain an understanding of the applicable financial reporting framework and to evaluate whether the company's selection and application of accounting principles are consistent with the applicable accounting framework and the accounting principles used in the relevant industry.[64] Such procedures can provide important information for identifying relevant matters such as (1) accounts that are susceptible to misstatement, e.g., if an account balance is determined using accounting principles that are inconsistent with the applicable financial reporting framework or (2) more general conditions that affect risks of material misstatement, e.g., if the company's selection or application of accounting principles is more aggressive than prevailing practices in the relevant industry.

In connection with obtaining an understanding of the applicable financial reporting framework and evaluating the company's selection and application of accounting principles, including related disclosures, Auditing Standard No. 12 requires the auditor to develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.[65] The language in this requirement was revised to clarify that the auditor should develop an expectation about the disclosures as part of the risk assessment procedures and that the expectations should be based on the disclosures necessary for the fair presentation of the financial statements in conformity with the applicable financial reporting framework.

Auditing Standard No. 12 also presents a list of matters that, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles.[66] The amount of auditor attention devoted to an individual matter would depend on its importance in meeting the overall requirements for obtaining an understanding of the company and performing risk assessment procedures.[67]

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[63] See AU sec. 316 and AU sec. 380, *Communication With Audit Committees*.

[64] Paragraph 12 of Auditing Standard No. 12.

[65] Ibid.

[66] Paragraph 13 of Auditing Standard No. 12.

[67] Paragraphs 4 and 7 of Auditing Standard No. 12.

3. Company Objectives, Strategies, and Related Business Risks

The reproposed standard required the auditor to obtain an understanding of the company's objectives, strategies, and related business risks in order to identify those business risks that could reasonably be expected to result in material misstatement of the financial statements. The *PAE Report* recommended that auditors be required to obtain an understanding of the company's business risks.[68/]

Commenters on the reproposed standard requested additional discussion about business risks, including going concern risks, fraud risks, and how business risks can result in misstatements of the financial statements. Additional discussion has been added to Auditing Standard No. 8 and Auditing Standard No. 12.[69/]

Auditing Standard No. 12 discusses how business risks can lead to misstatements and provides examples of business risks that may result in a risk of material misstatement of the financial statements.[70/] However, the list of examples is meant to be illustrative rather than a checklist of factors to consider. Auditors would need to consider the business risks that are relevant to the particular company and industry. For example, in today's economic environment, business risks might include financing risks (e.g., access to necessary financing) or product risks (e.g., investments in certain financial products).

4. The Company's Measurement and Analysis of its Financial Performance

The risk assessment procedures in the reproposed standard included obtaining an understanding of the company's performance measures. The purpose of obtaining that understanding is to identify those performance measures, whether external or internal, that affect the risks of material misstatement. For example, understanding performance measures can help the auditor identify accounts or disclosures that might be susceptible to manipulation to achieve certain performance targets (or to conceal failures to achieve those targets) or to understand how management uses performance measures to monitor risks affecting the financial statements.

[68/] *PAE Report,* p. 20.

[69/] Paragraph 6 of Auditing Standard No. 8 and the note to paragraph 15 of Auditing Standard No. 12.

[70/] Paragraphs 5 and 14-15 of Auditing Standard No. 12.

Commenters requested clarification regarding the examples of performance measures. A note was added to Auditing Standard No. 12 to explain the significance of the individual examples.[71/]

E. Obtaining an Understanding of Internal Control Over Financial Reporting

Auditing Standard No. 12 describes the auditor's responsibilities for obtaining an understanding of internal control over financial reporting ("understanding of internal control"). Auditing Standard No. 12 requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.[72/] These requirements are, in substance, equivalent to those in AU sec. 319, but the formulation in the proposed standard is aligned more clearly with Auditing Standard No. 5. Like the requirements in AU sec. 319, the requirements in Auditing Standard No. 12 indicate that although the auditor's primary focus is on internal control over financial reporting, the auditor may obtain an understanding of controls related to operations or compliance objectives if they pertain to data that the auditor plans to use in applying auditing procedures.[73/]

Auditing Standard No. 12 sets forth certain principles regarding the sufficiency of the auditor's understanding of internal control. The size and complexity of the company; the auditor's existing knowledge of the company's internal control; the nature of the company's internal controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting affect the nature, timing, and extent of procedures necessary to obtain an understanding of internal control. For example, the auditor's procedures to obtain an understanding of internal control would be more extensive when the auditor plans to test controls more extensively (e.g., in an integrated audit), the company's internal control is more complex, or the company's controls have changed significantly.

71/ Paragraph 17 of Auditing Standard No 12.

72/ Paragraph 18 of Auditing Standard No. 12.

73/ Paragraph 19 of Auditing Standard No. 12.

The reproposed standard stated that the auditor's understanding of internal control includes evaluating the design of controls and determining whether the controls are implemented. Commenters observed that the reproposed standard stated that walkthroughs that include the necessary procedures ordinarily are sufficient to evaluate design effectiveness, but the reproposed standard did not make a similar statement about the use of walkthroughs to determine whether controls have been implemented. Auditing Standard No. 12 has been revised to include a statement that walkthroughs that include the procedures described in the standard ordinarily are sufficient to determine whether a control has been implemented.[74/] Under Auditing Standard No. 12, as under AU sec. 319,[75/] the amount of audit attention devoted to design and operating effectiveness will vary based on the auditor's plan for testing controls. For example, if the auditor plans to test controls, more attention should be devoted to controls that the auditor plans to test.

1. Obtaining an Understanding of Individual Components of Internal Control Over Financial Reporting

To describe the auditor's responsibilities for obtaining an understanding of internal control, it was necessary to describe the components of internal control over financial reporting. The components described in Auditing Standard No. 12 are similar to those in AU sec. 319.[76/] Auditing Standard No. 12 also states that auditors may use other suitable, recognized frameworks[77/] in accordance with the provisions of the standard. If the auditor uses a suitable, recognized internal control framework with components that differ from those in the standard, the auditor should adapt the requirements in the standard for the components in the framework used.[78/]

74/ Paragraph 20 of Auditing Standard No. 12.

75/ AU sec. 319.58.

76/ Paragraph 21 of Auditing Standard No. 12.

77/ See Securities Exchange Act Release No. 34-47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

78/ Paragraph 22 of Auditing Standard No. 12.

2. Control Environment

Auditing Standard No. 12 requires the auditor to assess the following matters as part of obtaining an understanding of the control environment:

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.[79/]

Although this requirement is aligned with a similar requirement in Auditing Standard No. 5 for evaluating the control environment, the auditor's process for assessing the control environment in an audit of financial statements only is not expected to be the same as that required when expressing an opinion on internal control over financial reporting. For audits of financial statements only, Auditing Standard No. 12 allows the auditor to base his or her assessment on evidence obtained as part of obtaining an understanding of the control environment and other relevant knowledge possessed by the auditor.[80/]

Because of the importance of an effective control environment to address fraud risks, Auditing Standard No. 12 states that if the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor.[81/]

3. The Company's Risk Assessment Process

Auditing Standard No. 12 requires the auditor to obtain an understanding of management's risk assessment process for (a) identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud, (b) assessing the likelihood and significance of misstatements resulting from those risks, and (c)

79/ Paragraph 24 of Auditing Standard No. 12.

80/ Ibid.

81/ Paragraph 25 of Auditing Standard No. 12.

deciding about actions to address those risks.[82] The standard also requires the auditor to obtain an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.[83] Compliance with these requirements will help make sure that the auditor's risk assessments are appropriately informed by management's risk assessments and the controls that management put in place to address the risks.

4. Information and Communication

The reproposed standard required the auditor to obtain an understanding of the information system, including the related business processes, relevant to financial reporting. One commenter suggested removing the requirement to understand the company's business processes. The requirement was retained as reproposed.[84] Obtaining an understanding of the company's business processes assists the auditor in obtaining an understanding of how transactions are initiated, authorized, processed, and recorded. Also, the requirement to understand business processes is a recommendation in the *PAE Report*.[85] Auditing Standard No. 12 describes the necessary understanding of business processes to help auditors identify those business processes that are relevant to financial reporting.[86]

Auditing Standard No. 12 also contains requirements for understanding the period-end financial reporting process[87] and describes important elements of that process.[88] Because the period-end financial reporting process is a common source of potential misstatements, it is important for the auditor to have an adequate

[82] Paragraph 26 of Auditing Standard No. 12.

[83] Paragraph 27 of Auditing Standard No. 12.

[84] Paragraph 28 of Auditing Standard No. 12.

[85] *PAE Report,* p. 15.

[86] Paragraphs 28-32 of Auditing Standard No. 12.

[87] AU sec. 319.49 used the term "financial reporting process used to prepare the entity's financial statements," but Auditing Standard No. 12 uses the same term as used in Auditing Standard No. 5.

[88] Paragraphs 28 and 32 of Auditing Standard No. 12.

understanding of the aspects of the period-end financial reporting process in all audits, including audits of financial statements only. Auditing Standard No. 12 requires the auditor only to obtain an understanding[89/] of the process, as compared to Auditing Standard No. 5, which requires the auditor also to evaluate that process in the audit of internal control.

To appropriately highlight the importance of IT risks in determining the scope of the audit, the standard requires the auditor to obtain an understanding of how IT affects the company's flow of transactions. The standard also contains a note that states that the identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the approach used to identify significant accounts and disclosures and their relevant assertions and, when applicable, to select the controls to test, as well as to assess risk and allocate audit effort.

Regarding the auditor's understanding of communication, one commenter suggested that the standard clarify that the auditor should understand how the company communicates financial reporting roles and responsibilities and significant matters relating to financial reporting. The requirement in Auditing Standard No. 12 has been revised to clarify that point.[90/]

5. Control Activities

The reproposed standard required the auditor to obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures. As under AU sec. 319, a more extensive understanding of control activities is needed in areas in which the auditor plans to test controls. Thus, for purposes of evaluating the effectiveness of internal control over financial reporting in an integrated audit, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than that which is normally obtained in an audit of financial statements only.

Some commenters expressed concern that the language in the requirement could be misinterpreted as requiring the auditor to obtain an understanding of all controls, even in an audit of financial statements only in which the auditor does not plan

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89/ Paragraph 20 of Auditing Standard No. 12 discusses procedures that the auditor performs to obtain an understanding of internal control.

90/ Paragraph 33 of Auditing Standard No. 12.

to test controls. A few commenters suggested framing the requirement in terms of understanding control activities relevant to the audit.

The Board did not intend to expand the auditor's responsibilities for obtaining an understanding of control activities beyond what is required in AU sec. 319. The discussion in Auditing Standard No. 12 on obtaining an understanding of control activities has been revised, primarily using language adapted from AU sec. 319, to clarify that the substance of the requirement has not changed.[91/]

6. Performing Walkthroughs

The original proposed standard referred auditors to Auditing Standard No. 5 for a discussion of the performance of walkthroughs. Some commenters on the original proposed standard stated that the standard should include a discussion of walkthroughs rather than referring to Auditing Standard No. 5. The reproposed standard included a discussion of performing walkthroughs as part of meeting certain specified objectives, which paralleled a requirement in Auditing Standard No. 5[92/] regarding understanding likely sources of potential misstatements. Some commenters expressed concerns that the discussion would lead to unnecessary walkthroughs, particularly in audits of financial statements only.

The intention of including the discussion of walkthroughs was to explain how to perform walkthroughs rather than to impose requirements regarding when walkthroughs should be performed. The standard has been revised to focus on how the auditor should perform walkthroughs, e.g., in connection with understanding the flow of transactions in the information system relevant to financial reporting, evaluating the design of controls relevant to the audit, and determining whether those controls have been implemented.[93/] The discussion of the objectives for understanding likely sources of potential misstatements has been removed from Auditing Standard No. 12, so those objectives would continue to apply only to integrated audits.

91/ AU sec. 319.42 and paragraph 34 of Auditing Standard No. 12.

92/ Paragraph 34 of Auditing Standard No. 5.

93/ Paragraph 37 of Auditing Standard No. 12.

7. Relationship of Understanding of Internal Control to Tests of Controls

Auditing Standard No. 12, like the reproposed standard, contains a discussion about the relationship between obtaining an understanding of controls and testing controls, including entity-level controls.[94/] The requirements in Auditing Standard No. 12 clarify that the objective of obtaining an understanding of internal control as a risk assessment procedure is different from testing controls for the purpose of assessing control risk[95/] or for the purpose of expressing an opinion on internal control over financial reporting in the audit of internal control.[96/] The standard allows the auditor the flexibility of obtaining an understanding of internal control concurrently with performing tests of controls if he or she obtains sufficient appropriate evidence to achieve the objectives of both procedures.[97/]

F. Information Obtained from Past Audits and Other Engagements

1. Information from Past Audits

The reproposed standard included a requirement for the auditor to incorporate knowledge obtained during past audits into the auditor's process for identifying risks of material misstatement. One commenter asked for clarification of the meaning of the term "incorporate." Two commenters stated that the most important issue is to determine whether information from past audits is still relevant.

The term "incorporate" is not new and should be familiar to most auditors. For example, it has been used in AU sec. 316 regarding the requirement to incorporate an element of unpredictability in the audit in response to fraud risks. The requirement in the reproposed standard was similar to a requirement in Auditing Standard No. 5 to incorporate knowledge obtained during past audits in subsequent year audits of internal control.[98/] Accordingly the term has been retained in Auditing Standard No. 12.

94/ Paragraph 39 of Auditing Standard No. 12.

95/ Paragraphs 16-31 of Auditing Standard No. 13.

96/ Paragraph B1 of Auditing Standard No. 5.

97/ Paragraph 39 of Auditing Standard No. 12.

98/ Paragraph 57 of Auditing Standard No. 5.

Auditing Standard No. 12 also states that if the auditor plans to limit the nature, timing, or extent of his or her risk assessment procedures by relying on information from past audits, the auditor should evaluate whether the prior-years' information remains relevant and reliable.[99/]

2. Information from Other Engagements

The reproposed standard included a requirement for the auditor to take into account relevant information obtained through other engagements performed by the auditor for the company.[100/] This requirement was intended to focus on the responsibility to take relevant information into account in identifying and assessing risks rather than to prescribe a particular method for obtaining that information.

Some commenters suggested that the requirement should be limited to consideration of other engagements performed by the engagement partner. The suggested change would weaken the standard. Limiting the consideration of information to engagements performed for the company by the engagement partner is too narrow because it omits other important information sources that are available to the engagement team. Also, limiting the consideration to engagements performed by the engagement partner is inconsistent with prior PCAOB standards. For example, AU sec. 311.04 stated that procedures the auditor may consider in planning an audit usually involve discussions with other firm personnel, and includes the following example "Discussing matters that may affect the audit with firm personnel responsible for non-audit services to the entity." Also, paragraph 03 of AU sec. 9311, *Planning and Supervision: Auditing Interpretations of Section 311*, stated:

> The auditor should consider the nature of non-audit services that have been performed. He should assess whether the services involve matters that might be expected to affect the entity's financial statements or the performance of the audit, for example, tax planning or recommendations on a cost accounting system. If the auditor decides that the performance of the non-audit services or the information likely to have been gained

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[99/] Paragraph 43 of Auditing Standard No. 12.

[100/] PCAOB Rule 1001, *Definitions of Terms Employed in Rules,* states that, when used in rules of the PCAOB, unless the context otherwise requires, "[t]he term 'auditor' means both public accounting firms registered with the Public Company Accounting Oversight Board and associated persons thereof."

> from it may have implications for his audit, he should discuss the matter with personnel who rendered the services and consider how the expected conduct and scope of his audit may be affected. In some cases, the auditor may find it useful to review the pertinent portions of the work papers prepared for the non-audit engagement as an aid in determining the nature of the services rendered or the possible audit implications.

Other commenters suggested that the requirement be revised to use more of the language from AU sec. 9311. The requirement in Auditing Standard No. 12[101/] has been revised as follows:

> The auditor should obtain an understanding of the nature of the services that have been performed for the company by the auditor or affiliates of the firm[102/] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement.[103/]

One commenter stated that audit firms will need to develop very costly reporting systems to enable them to convey relevant information about nonassurance engagements to audit engagement teams. Existing PCAOB and SEC rules already require firms to track and report nonaudit services provided to the company. Complying with these requirements would mean that the audit firms have a mechanism in place to track these services. For example, PCAOB Rules 3524[104/] and 3526[105/] require the auditor to describe to the company's audit committee, among other things, the scope of and the potential effect on independence of other services provided by the firm. It is expected that the system used to capture, track, and monitor these services for compliance with these PCAOB independence rules would also be applicable to comply with the requirements of Auditing Standard No. 12.

[101/] Paragraph 45 of Auditing Standard No. 12.

[102/] PCAOB Rule 3501, *Definitions of Terms Employed in Section 3, Part 5 of the Rules*.

[103/] Paragraph 7 of Auditing Standard No. 9.

[104/] PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*.

[105/] PCAOB Rule 3526, *Communication With Audit Committees Concerning Independence.*

G. Performing Analytical Procedures

The reproposed standard retained requirements from AU sec. 329, *Analytical Procedures*, to perform analytical procedures during the planning phase of the audit.[106/] Such analytical procedures are, in essence, risk assessment procedures, so the respective requirements and direction have been incorporated into Auditing Standard No. 12.[107/] One commenter stated that it is unclear whether the PCAOB intends a change in practice regarding the execution of analytical procedures performed as risk assessment procedures, e.g., because the requirements in the reproposed standard discussed developing expectations and comparing them to recorded amounts. AU sec. 329, states that analytical procedures involve developing expectations and comparing those expectations to recorded amounts.[108/]

Auditing Standard No. 12 states that analytical procedures performed as risk assessment procedures often use data that is preliminary or data that is aggregated at a high level and that in those instances such analytical procedures are not designed with the level of precision necessary for substantive analytical procedures.[109/] In those situations, the auditor's expectations in performing analytical procedures as risk assessment procedures do not require the same degree of precision as substantive analytical procedures.

H. Conducting a Discussion among Engagement Team Members Regarding Risks of Material Misstatement

Like the reproposed standard, Auditing Standard No. 12 includes a requirement that key engagement team members discuss (1) the company's selection and application of accounting principles, including related disclosure requirements and (2) the susceptibility of the company's financial statements to material misstatement due to error or fraud.[110/] The standard explains that key engagement team members include the engagement partner and all engagement team members who have significant

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[106/] AU secs. 329.06-.08.

[107/] Paragraphs 46-48 of Auditing Standard No. 12.

[108/] AU sec. 329.05.

[109/] Paragraph 48 of Auditing Standard No. 12.

[110/] Paragraph 49 of Auditing Standard No. 12.

engagement responsibilities.[111] The term "significant engagement responsibilities" should be familiar to auditors because it is already used in AU sec. 316 regarding the appropriate assignment of engagement team members in the overall responses to fraud risks.

One commenter stated that the requirement for participation in the discussion among engagement team members on the reproposed standard should be revised to use the language in ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*, so that the engagement partner makes the determination of what needs to be reported to whom on a "need to know" basis.

The language in Auditing Standard No. 12 was retained as reproposed. The Board believes that the discussion among engagement team members is an important part of the auditor's risk assessment procedures. Through its oversight activities, the Board has observed deficiencies relating to discussions among engagement team members regarding fraud risks, including instances in which key engagement team members did not participate.[112]

1. Discussion of the Potential for Material Misstatement Due to Fraud

A number of comments were received regarding the requirements for discussing the risks of material misstatement due to fraud.

One commenter suggested that the standard should require the auditor to consider using a fraud specialist. The Board believes that this point is already covered by the requirement in Auditing Standard No. 9 to evaluate whether a person with specialized skill or knowledge is needed to assess risks.[113]

One commenter suggested that the requirement to discuss how the financial statements could be materially misstated through omitting or presenting incomplete disclosures also should include the possibility of presenting inaccurate disclosures. The

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[111] Paragraph 50 of Auditing Standard No. 12.

[112] PCAOB Release 2007-001, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud* (January 22, 2007).

[113] Paragraphs 16-17 of Auditing Standard No. 12.

requirement has been revised to include that topic.[114] Another commenter stated that the standard should provide more "guidance" about how fraud risks relate to disclosures. The manner in which management might intentionally omit disclosures or present inaccurate or incomplete disclosures to commit or conceal intentional misstatement of the financial statements necessarily depends on the circumstances, including the incentives or pressures and the opportunities to manipulate the financial statements. The discussion of fraud risks required by the standard should prompt engagement team members to consider ways in which omissions or inaccuracies in disclosures might be involved with fraudulent financial reporting.

Another commenter stated that the requirement for the auditor to emphasize certain matters regarding fraud to the engagement team members during the fraud risk discussion does not assign the responsibility to a specific person. The requirement focuses on the communication of important matters rather than on the person communicating the matters. Since the engagement partner has the overall responsibility for the audit engagement, the engagement partner is likely to be the most appropriate person to make the communications. However, Auditing Standard No. 12 allows the communications to be made by another engagement team member, when appropriate.

2. Communication Among Engagement Team Members

Auditing Standard No. 12 states that communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change. This requirement carries forward and builds upon a requirement in AU sec. 316.[115]

I. Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

Like the reproposed standard, Auditing Standard No. 12 requires the auditor to make inquiries of the audit committee, or equivalent (or its chair), management, the internal audit function, and others within the company who might reasonably be expected to have information that is important to the identification and assessment of risks of material misstatement.[116] The requirement to inquire of others who "might

[114] Paragraph 52 of Auditing Standard No. 12.

[115] AU sec. 316.18.

[116] Paragraph 54 of Auditing Standard No. 12.

reasonably be expected to have information" is similar to a requirement in AU sec. 316 for making inquiries of others about the existence or suspicion of fraud, and it establishes a principle to guide the auditor in determining those other persons to whom the inquiries should be addressed.[117/]

1. Inquiries Regarding Fraud Risks

The reproposed standard also required the auditor to make inquiries of the audit committee (or its chair), management, the internal audit function, and others within the company about the risks of fraud. Commenters suggested that the requirements for identifying other individuals within the company to whom inquiries should be directed should include determining the extent of such inquiries. Auditing Standard No. 12 reflects the suggested revision to that requirement because inquiries of other individuals should be designed to obtain information relevant to identifying and assessing fraud risks.[118/]

The reproposed standard included a requirement to take into account the fact that management is often in the best position to commit fraud when evaluating management's responses to inquiries about fraud risks and determining when it is necessary to corroborate management's responses. One commenter stated that the requirement was unclear and the use of the term "take into account" did not seem consistent with the Board's explanation in the release accompanying the reproposed standards. This requirement has been revised to clarify the requirement and to use "take into account" in a manner that is consistent with the other PCAOB standards.[119/]

Auditing Standard No. 12 requires that the auditor use his or her knowledge of the company and its environment, as well as information from other risk assessment procedures, to determine the nature of the inquiries about risks of material misstatement. This requirement carries forward and builds upon a requirement in AU sec. 316.[120/]

Auditing Standard No. 12 includes an additional required inquiry of the internal auditor about whether he or she is aware of instances of management override of

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117/ AU sec. 316.24.

118/ Paragraph 57 of Auditing Standard No. 12.

119/ Paragraph 58 of Auditing Standard No. 12.

120/ AU sec. 316.24.

controls and the nature and circumstances of such overrides. Also, Auditing Standard No. 12 requires the auditor to make inquiries of management and the audit committee, or equivalent regarding tips or complaints about the company's financial reporting.[121/] These required inquiries were added in light of research indicating that many incidents of fraud are uncovered through tips.[122/] These inquiries can provide important evidence about fraud risks.

Auditing Standard No. 12 requires the auditor, when evaluating management's responses to inquiries about fraud risks and determining when it is necessary to corroborate management's responses, to take into account the fact that management is often in the best position to commit fraud. The standard also requires the auditor to obtain evidence to address inconsistencies in responses to inquiries. This requirement carries forward and builds upon a requirement in AU sec. 316.[123/]

J. Identifying and Assessing the Risks of Material Misstatement

Auditing Standard No. 12 sets forth a process for identifying and assessing the risks of material misstatement using the information obtained from the risk assessment procedures and other relevant knowledge possessed by the auditor.[124/] This process involves:

a. Identifying risks of misstatement using information obtained from risk assessment procedures and considering the characteristics of the accounts and disclosures in the financial statements.

[121/] Paragraph 56 of Auditing Standard No. 12.

[122/] See, e.g., Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud & Abuse* (2008).

[123/] AU sec. 316.27.

[124/] Under Auditing Standard No. 12, the auditor has a responsibility to perform risk assessment procedures that provide an appropriate basis for his or her risk assessment. Auditing Standard No. 12 does not include the provision in the prior interim standards that allowed the auditor to assess risk at the maximum solely for efficiency reasons. Rather, the auditor needs to have a sufficient understanding of the company and its environment, including its internal control, in order to determine the risks of material misstatement and, in turn, to design effective tests of controls and substantive procedures.

b. Evaluating whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions.

c. Evaluating the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected. This includes evaluating how risks at the financial statement level could affect risks at the assertion level.

d. Assessing the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements. In making this assessment, the auditor may take into account the planned degree of reliance on controls that the auditor plans to test, if the auditor performs tests of controls in accordance with PCAOB standards.

e. Identifying significant accounts and disclosures and their relevant assertions.

f. Determining whether any of the identified and assessed risks of material misstatement are significant risks.[125/]

One commenter suggested that the word "material" should be inserted before the word "misstatement" in paragraph 56.a. of the reproposed standard. No change was made to Auditing Standard No. 12 because inserting the word "material" would inappropriately narrow the auditor's focus on only material risks too early in the process of identifying and assessing risks of misstatement, i.e., before assessing the likelihood and magnitude of potential misstatements related to the risks.

Commenters suggested that the standard should clarify that the likelihood and magnitude of potential misstatements should be considered in determining which risks are significant risks. Auditing Standard No. 12 includes an additional requirement that states, "To determine whether an identified and assessed risk is a significant risk, the auditor should evaluate whether the risk requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk."[126/] Also, the list of factors that should be evaluated in determining which

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[125/] Paragraph 59 of Auditing Standard No. 12.

[126/] Paragraph 70 of Auditing Standard No. 12.

risks are significant risks was expanded to include "the effect of the quantitative and qualitative risk factors discussed in paragraph 60 of the standard [on identifying significant accounts and disclosures and their relevant assertions] on the likelihood and potential magnitude of misstatements."[127/] Including this new factor highlights the relationship between the identification of significant accounts and disclosures and their relevant assertions and the identification of significant risks. Specifically, risk factors that form the basis for identifying significant accounts and disclosures and their relevant assertions also inform the identification of significant risks, and significant risks affect one or more relevant assertions of significant accounts or disclosures.

Another commenter on the reproposed standard suggested that the term "likelihood" be defined more in terms of reasonable possibility as that term is used in Auditing Standard No. 5. However, that change would be inconsistent with the requirement to assess the likelihood of misstatements, i.e., the possibility that the risk would result in misstatement of the financial statements.

One commenter indicated that the requirement in the note to paragraph 59.c. of the reproposed standard "inappropriately infers that the auditor should, and can, associate the risks at the financial statement level with particular assertions in order to assess risks at the assertion level." Auditing Standard No. 8 states that risks of material misstatement at the financial statement level have a pervasive effect on the financial statements as a whole and potentially affect many assertions, and the standard provides examples of how risks at the financial statement level can result in misstatements.[128/] It is important for the auditor to take into account risks of material misstatement at the financial statement level in order to evaluate types of misstatements that could occur.

Under PCAOB standards, significant accounts and disclosures and their relevant assertions are identified based upon their risk characteristics. Thus, the auditor needs to identify and assess the risks in order to identify the relevant assertions of significant accounts and disclosures in accordance with PCAOB standards. For example, Auditing Standard No. 5 requires the auditor to identify significant accounts and disclosures and their relevant assertions in integrated audits.[129/] Also, AU sec. 319 required the auditor

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127/ Paragraph 71 of Auditing Standard No. 12.

128/ Paragraph 6 of Auditing Standard No. 8.

129/ Paragraph 28 of Auditing Standard No. 5.

to perform substantive procedures for the relevant assertions of significant accounts and disclosures for all audits of financial statements, which implicitly required the auditor to identify those accounts, disclosures, and assertions.[130/] Auditing Standard No. 12 imposes a more explicit requirement on the auditor to identify significant accounts and disclosures and their relevant assertions in all audits.

1. Factors Relevant to Identifying Fraud Risks

Auditing Standard No. 12 requires that the auditor evaluate whether the information gathered from the risk assessment procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks.[131/] The reproposed standard included a paragraph that stated that the auditor should not assume that all of the fraud risk factors discussed in must be observed to conclude that a fraud risk exists. Commenters suggested that the language was not clear as to the action that auditors would need to take to "not assume." The paragraph has been revised to clarify that all of the conditions are not required to be observed or evident to conclude that a fraud risk exists.[132/]

2. Consideration of the Risk of Omitted or Incomplete Disclosures

The reproposed standard stated that the auditor's evaluation of fraud risk factors should include an evaluation of how fraud could be perpetrated or concealed by omitting required disclosures or by presenting incomplete disclosures. One commenter stated that the requirement should also include consideration of the possibility of presenting inaccurate disclosures. Other commenters stated that the requirement should be revised to refer to disclosures required by the applicable financial reporting framework. The requirement has been revised to encompass inaccurate disclosures and to refer to disclosures required for the fair presentation of the financial statements in conformity with the applicable financial reporting framework.[133/]

130/ Ibid.

131/ Paragraph 65 of Auditing Standard No. 12.

132/ Paragraph 66 of Auditing Standard No. 12.

133/ Paragraph 67 of Auditing Standard No. 12.

3. Presumption of Fraud Risk Involving Improper Revenue Recognition

Like the reproposed standard, Auditing Standard No. 12 contains a requirement that the auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.[134/] One commenter recommended rewording this paragraph to state that while revenue recognition should be presumed to be a higher level of risk, there are exceptions. The requirement was retained as stated in the reproposed standard because a significant number of financial reporting frauds relate to revenue recognition.[135/]

K. Definition of Significant Risk

The reproposed standard defined significant risk as a risk of material misstatement that requires special audit consideration. Some commenters stated that the definition of "significant risk" in the reproposed standard should be revised to indicate that significant risks are "identified risks" and that they are determined using the "auditor's judgment" or risks that the auditor "determines." Adding a reference to the auditor's determination or auditor's judgment is unnecessary because those points are inherent in the requirements for identifying significant risks, e.g., in the required evaluation of the likelihood and potential magnitude of misstatements related to the risk. Similarly, the reference to "identified risks" is unnecessary because it is already mentioned in the requirement for determining significant risks. Accordingly, the definition of significant risk included in the reproposed standard is retained.

VII. Auditing Standard No. 13 – The Auditor's Responses to the Risks of Material Misstatement

A. Background

Auditing Standard No. 13 establishes requirements for responding to the risks of material misstatement, including responses regarding the general conduct of the audit and responses involving audit procedures. Auditing Standard No. 13 applies to integrated audits and audits of financial statements only.

[134/] Paragraph 68 of Auditing Standard No. 12.

[135/] See, e.g., Committee of Sponsoring Organizations of the Treadway Commission, *Fraudulent Financial Reporting: 1998-2007* (May 2010).

B. Linking Assessed Risks and Auditor's Responses

The reproposed standard included a requirement for the auditor to design and implement appropriate responses to the "assessed risks of material misstatement" to address comments received on the original proposed standard for improving the linkage between the auditor's responses and the identification and assessment of risks of material misstatement. Acknowledging the improvements in the reproposed standard, some commenters continued to suggest that the objective also should state that the auditor is to address the assessed risks of material misstatement.

In the Board's view, obtaining sufficient appropriate evidence to support the auditor's opinion requires the auditor to adequately respond to the risks of material misstatement. Accordingly, the title and objective of the standard continue to refer to responding to the risks of material misstatement. However, the Board recognizes that the appropriate identification and assessment of the risks of material misstatement in accordance with Auditing Standard No. 12 enable the auditor to effectively respond to the risks of material misstatement. Auditing Standard No. 13 continues to impose on auditors an unconditional responsibility to design and implement responses that address the risks of material misstatement identified and assessed in accordance with Auditing Standard No. 12.[136/] As with the reproposed standard, noncompliance with the requirements in Auditing Standard No. 12 that leads to a failure to identify or appropriately assess a risk of material misstatement also could result in a failure to appropriately respond to the risk of material misstatement in accordance with this standard.[137/]

C. Overall Responses to Risks

The reproposed standard included a requirement for the auditor to respond to the risks of material misstatement through overall responses and responses involving the nature, timing, and extent of audit procedures. Overall responses relate to the general conduct of the audit, e.g., appropriately assigning and properly supervising engagement team members, incorporating an element of unpredictability into the audit, evaluating the company's selection and application of significant accounting principles, and making pervasive changes to the audit. Such responses are required by AU sec. 316 in

136/ Paragraph 3 of Auditing Standard No. 13.

137/ Failure to address a risk of material misstatement also might indicate a failure to comply with Auditing Standard No. 12.

response to fraud risks, but the reproposed standard extended the requirement to apply to risks of material misstatement due to error or fraud. These responses, by their nature, are appropriate for addressing risks of material misstatement due to error or fraud.

Some commenters expressed concerns regarding the expansion of the requirement for incorporating an element of unpredictability to apply to risks of material misstatement other than fraud risks.

In the Board's view, although incorporating an element of unpredictability is intended primarily to address fraud risks, it also can enable the auditor to detect errors or control deficiencies that could otherwise remain undetected. In addition, the requirement to incorporate an element of unpredictability when testing controls already exists in Auditing Standard No. 5. Auditing Standard No. 13 continues to indicate that the auditor should incorporate an element of unpredictability as part of the response to the risks of material misstatement, including fraud risks.[138/]

One commenter requested clarification regarding the differences between the first and third examples used to illustrate ways to incorporate an element of unpredictability in paragraph 5.c. of the reproposed standard. The first example in Auditing Standard No. 13 is intended to illustrate that the auditor may decide to perform audit procedures for a particular account, disclosure, or assertion even though the auditor's risk assessment did not identify specific risks associated with those accounts.[139/] The third example is intended to illustrate that when sampling a particular financial statement amount, the auditor may consider selecting items with amounts lower than the threshold that the auditor had used in the past, or expanding the selection to other sections of the population that the auditor had not tested in the past.[140/]

The reproposed standard required the auditor to evaluate whether it is necessary to make pervasive changes to the audit to adequately address the assessed risks of material misstatement. The reproposed standard did not require that pervasive changes be made in every audit. Instead, it required the auditor to evaluate whether pervasive changes that affect many aspects of the audit are needed to address the assessed risks

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[138/] Paragraph 5.c. of Auditing Standard No. 13.

[139/] Paragraph 5.c. (1) of Auditing Standard No. 13.

[140/] Paragraph 5.c. (3) of Auditing Standard No. 13.

of material misstatement. Commenters questioned the use of the term "pervasive" in the requirement. Auditing Standard No. 13 provides additional explanation of the types of circumstances in which pervasive changes might be necessary.[141/]

Existing PCAOB standards require the auditor to apply professional skepticism as part of due care,[142/] and Auditing Standard No. 13 states that the auditor's response to fraud risks involves the application of professional skepticism in gathering and evaluating audit evidence.[143/] The requirement is intended to emphasize the importance of professional skepticism in responding to risks of material misstatement without limiting its application to the auditor's responses.

One commenter expressed concern that the reproposed standard did not explicitly require the auditor to implement overall responses to risks at the financial statement level. Such an explicit requirement would inappropriately limit the auditor's overall responses to risks at the financial statement level. Many of the overall responses also apply to risks at the assertion level, e.g., assigning more experienced personnel or applying a greater extent of supervision to accounts or disclosures with higher risk.

D. Responses Involving the Nature, Timing, and Extent of Audit Procedures

The reproposed standard required the auditor to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure. Auditing Standard No. 13 retained this requirement as reproposed. The requirement emphasizes that the auditor should focus on each relevant assertion of each significant account and disclosure and the risks of material misstatement associated with the relevant assertion when designing and performing audit procedures.

The reproposed standard also included requirements for the auditor to design the testing of controls to accomplish the objectives of both the audit of financial statements and the audit of internal control in an integrated audit. This requirement is aligned with Auditing Standard No. 5. One commenter suggested that that the requirement be removed because it relates only to integrated audits. The requirement was retained as reproposed because Auditing Standard No. 13 applies to integrated audits as well as

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141/ Paragraph 6 of Auditing Standard No. 13.

142/ AU secs. 230.07-.09.

143/ Paragraph 7 of Auditing Standard No. 13.

audits of financial statements only, and tests of controls are a necessary response in the audit of internal control.[144/]

E. Tests of Controls in an Audit of Internal Control

Auditing Standard No. 13 includes requirements for performing tests of controls in the audit of financial statements.[145/]

In an integrated audit, the tests of controls performed in the audit of internal control are part of the auditor's responses to the risks of material misstatement, as indicated in paragraph 9-10 of Auditing Standard No. 13.[146/] To help facilitate the integration of tests of controls in an integrated audit, the standard continues to use language similar to that of Auditing Standard No. 5 when describing analogous terms and concepts relating to the testing of controls.

F. Tests of Controls and Control Risk Assessment in the Audit of Financial Statements

1. Requirements on When to Test Controls

AU sec. 319 required auditors to obtain evidence about the design effectiveness and operating effectiveness of controls (a) when the auditor plans to rely on selected controls to reduce his or her substantive procedures and (b) in those limited circumstances in which the auditor cannot obtain sufficient appropriate evidence through substantive procedures alone.[147/] Thus, except in those limited circumstances, AU sec. 319 provided auditors with flexibility to decide when or whether to test controls.

144/ Paragraph 9.c. of Auditing Standard No. 13.

145/ Paragraphs 16-35 of Auditing Standard No. 13.

146/ Paragraph 39 of Auditing Standard No. 5 states, "The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion."

147/ AU sec. 319.66.

Auditing Standard No. 13 does not change the requirements in AU sec. 319 regarding when testing controls is necessary in audits of financial statements only.[148] In those audits, auditors continue to have the same flexibility in deciding when or whether to test controls to reduce their substantive procedures.[149] Auditing Standard No. 13 includes additional statements that emphasize the flexibility that auditors have in making these decisions and provides additional examples, adapted from AU sec. 319.68, of situations in which auditors cannot obtain sufficient appropriate audit evidence through substantive procedures alone.[150]

2. Period of Reliance

Auditing Standard No. 13 states that when the auditor relies on controls to assess control risk at less than the maximum, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance.[151] The concept of the period of reliance was introduced in Auditing Standard No. 5 and discussed further in the PCAOB staff guidance, *Staff Views: An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements – Guidance for Auditors of Smaller Public Companies.* Auditing Standard No. 13 provides a definition of "period of reliance" that parallels the language in paragraph B4 of Auditing Standard No. 5.[152]

3. Evidence about the Effectiveness of Controls

Auditing Standard No. 13 describes the principle, adapted from AU sec. 319,[153] that the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. In

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[148] Certain clarifying revisions were made to the discussion of relying on controls to modify the auditor's substantive procedures, in response to comments on the reproposed standard. See footnote 12 to paragraph 16 of Auditing Standard No. 13.

[149] Paragraph 16 of Auditing Standard No. 13.

[150] Paragraph 17 of Auditing Standard No. 13.

[151] Paragraph 16 of Auditing Standard No. 13.

[152] Paragraph A.3 of Auditing Standard No. 13.

[153] AU sec. 319.90.

applying that principle, Auditing Standard No. 13 requires the auditor to obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. In addition, Auditing Standard No. 13 requires the auditor to obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.[154/]

4. Testing Operating Effectiveness

Auditing Standard No. 13 requires the auditor to determine, among other things, whether the person performing the control possesses the necessary authority and competence to perform the control effectively.[155/] This requirement is intended to call to the auditor's attention that whether he or she possesses the appropriate level of authority and the knowledge and skills necessary to perform the control function is essential to whether a person can effectively perform the control. Thus, the auditor is required to make such determination before he or she can conclude about the effectiveness of the control.

5. Timing of Tests of Controls – Evidence Obtained during an Interim Period

The reproposed standard stated that the auditor must obtain evidence about the effectiveness of controls selected for testing for the entire period of reliance. When the auditor tests controls during an interim period, additional evidence that is necessary concerning the operation of those controls for the remaining period of reliance depends on a series of factors listed in the reproposed standard, including, among other factors, the possibility of significant changes in internal control over financial reporting occurring subsequent to the interim date.

One commenter suggested adding "control environment" to the list of factors that could affect the auditor's determination of what additional evidence is necessary. The control environment has an important, but indirect, effect on the likelihood that a misstatement will be prevented or detected on a timely basis. Also, unlike monitoring controls, the control environment is not designed to identify possible breakdowns in other controls. Accordingly, the control environment, by itself, does not reduce the

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154/ Paragraph 18 of Auditing Standard No. 13.

155/ Paragraph 21 of Auditing Standard No. 13.

amount of evidence needed concerning controls over specific relevant assertions for the remaining period. The control environment is not included in the list of factors in Auditing Standard No. 13.

Another commenter suggested adding a requirement for the auditor to obtain, when applicable, audit evidence about subsequent changes to the controls tested during the interim period. A note has been added to Auditing Standard No. 13 requiring the auditor to obtain evidence about such subsequent changes, if significant.[156/]

6. Timing of Tests of Controls – Evidence from Past Audits

Auditing Standard No. 13 states that the auditor should obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies.[157/] This requirement is based on the principle that auditors should support their control risk assessments each year with current evidence. However, when the auditor has tested the controls in the past and plans to rely on the same controls for the current year audit, the amount of evidence needed will vary based on the relevant factors listed in the standard.[158/] These additional factors generally relate to the degree of reliance on the control, the risk that the control will fail to operate as designed, and the nature and amount of evidence that the auditor has already obtained regarding the effectiveness of the controls. These requirements are consistent with Auditing Standard No. 5. Also, the standard allows the auditor to use a benchmarking strategy, when appropriate, for automated application controls for subsequent years' audits, as do the provisions of Auditing Standard No. 5. However, the standard does not permit testing controls once every third year because the standard requires evidence regarding the effectiveness of controls to be obtained each year.

Some commenters expressed concern that the requirements in the reproposed standard for determining the amount of evidence needed in the current year could be interpreted as requiring the auditor to consider each factor listed for each of the controls that the auditor tested in the past, regardless of whether or not the auditor plans to rely on those controls for purposes of the current year audit. The requirement was intended to apply when the auditor tested the controls in the past audits and plans to rely on

156/ Paragraph 30 of Auditing Standard No. 13.

157/ Paragraph 31 of Auditing Standard No. 13.

158/ Ibid.

those controls and use evidence about the effectiveness of those controls obtained in prior years for purposes of the current year audit. That requirement is clarified in Auditing Standard No. 13.[159/]

7. Assessing Control Risk

Auditing Standard No. 13 requires the auditor to assess control risk for relevant assertions.[160/] This requirement is not new. AU sec. 319 established requirements for the auditor to assess control risk, and Auditing Standard No. 5 discusses control risk assessment in the financial statement audit portion of the integrated audit.[161/]

Auditing Standard No. 13 requires the auditor to assess the control risk at the maximum level for relevant assertions when the controls necessary to sufficiently address the assessed risk of material misstatement in those assertions are missing or ineffective or when the auditor has not obtained sufficient appropriate evidence to support a control risk assessment below the maximum level.[162/]

One commenter expressed a concern that the reproposed standard seemed to indicate that no reduction of the control risk assessment should occur based on understanding the design effectiveness of controls. The commenter suggested that a control that does not exist or is not designed effectively should have a different impact on the auditor's testing than a control that is designed effectively but not tested by the auditor.

The risk assessment standards already address the points raised by the commenter regarding the effect of control deficiencies on the auditor's testing. Auditing Standard No. 12 requires the auditor to obtain an understanding of the design of the company's controls as part of his or her risk assessment procedures.[163/] If the auditor identifies design deficiencies in the company's controls, the auditor would take that into

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[159/] Ibid.

[160/] Paragraphs 32-34 of Auditing Standard No. 13.

[161/] AU secs. 319.70, .83-.90 and paragraphs B4-B5 of Auditing Standards No. 5.

[162/] Paragraph 33 of Auditing Standard No. 13.

[163/] Paragraph 20 of Auditing Standard No. 12.

account in identifying and assessing the risks of material misstatement, and Auditing Standard No. 13 requires the auditor to implement responses to address those risks of material misstatement. When deficiencies are detected during the auditor's testing of controls that the auditor plans to rely on, Auditing Standard No. 13 requires the auditor to (1) perform tests of other controls related to the same assertion as the ineffective controls, or (2) revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased assessment of risk.[164/]

Another commenter suggested that the reproposed standard provide more direction about evaluating control deviations by adding a paragraph from Auditing Standard No. 5 regarding evaluating control deficiencies. The referenced paragraph does not apply specifically to assessing control risk in a financial statement audit, and Auditing Standard No. 13 requires the auditor to evaluate the evidence from all sources, including the results of test of controls, when assessing control risk for relevant assertions.[165/]

G. Substantive Procedures

Auditing Standard No. 13 requires the auditor to perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.[166/] By definition, a relevant assertion of a significant account and disclosure has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated.[167/] The requirement to obtain evidence from substantive procedures for each relevant assertion of each significant account and disclosure reflects the principle that the auditors need to implement appropriate responses to address the assessed risks of material misstatement.

Existing PCAOB standards indicate that some risks of material misstatement might require more evidence from substantive procedures because of certain inherent

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164/ Paragraph 34 of Auditing Standard No. 13.

165/ Paragraph 32 of Auditing Standard No. 13.

166/ Paragraph 36 of Auditing Standard No. 13.

167/ Paragraph A9 of Auditing Standard No. 5.

limitations of internal control.[168] For example, more evidence from substantive procedures ordinarily is needed for relevant assertions that have a higher susceptibility to management override or to lapses in judgment or breakdowns resulting from human failures. Observations from the Board's oversight activities have underscored the importance of this principle. Auditing Standard No. 13 includes this principle because it is particularly relevant to the determination of the nature, timing, and extent of substantive procedures. It is also consistent with the principles regarding detection risk discussed in Auditing Standard No. 8.

H. Timing of Substantive Procedures

The reproposed standard included a requirement for the auditor to take into account certain factors in determining whether it is appropriate to perform substantive procedures at an interim date. One commenter suggested that another point be added to the standard to require the auditor to review "the internal control changes that have been made to date and the nature and extent of monitoring such changes by the client staff." Auditing Standard No. 13 requires the auditor to consider the effect of known or expected changes in the company, its environment, and its internal control over financial reporting during the remaining period on its risk assessments when determining whether to perform substantive procedures at an interim date.[169] This additional requirement recognizes that both changes in controls and other changes to the company and its environment can affect the risks of material misstatement and, thus, the effectiveness of interim substantive procedures. For example, significant changes in industry or market conditions near year end could increase the risk of material misstatement regarding the valuation of assets at year end, which, in turn, would require significant audit attention during the remaining period.

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[168] See, e.g., paragraph .14 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures.*

[169] Paragraph 44.a.(3) of Auditing Standard No. 13.

The reproposed standard stated that when an auditor performs substantive procedures as of an interim date, the auditor should perform substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. The reproposed standard also required that the auditor perform certain procedures that were adapted from AU sec. 313.

Some commenters suggested that the Board remove the mandatory procedures in the reproposed standard, arguing that the procedures should be determined by the auditor based on professional judgment. Removing those requirements as suggested by the commenters would weaken PCAOB standards. Observations from the Board's oversight activities have included instances in which inadequate audit work was performed when extending the conclusion reached at the interim date to the end of the period covered by the financial statements. Therefore, retaining the mandatory procedures in this standard continues to be appropriate.[170/]

I. Substantive Procedures Responsive to Significant Risks

Like the original proposed standard, the reproposed standard stated that the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the significant risks. AU sec. 329 indicates that tests of details should be performed in response to significant risks.[171/]

One commenter continued to express concern about imposing a presumptively mandatory responsibility for auditors to perform tests of details in response to significant risks. Auditing Standard No. 13 retains the requirement as reproposed.[172/] The nature and importance of significant risks warrant a high level of assurance from substantive procedures to adequately address the risk. Also, analytical procedures alone are not well suited to detecting certain types of misstatements related to significant risks, including, in particular, fraud risks. For example, when fraud risks are present, management might be able to override controls to allow adjustments that result in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions.

170/ Paragraph 45 of Auditing Standard No. 13.

171/ AU sec. 329.09.

172/ Paragraph 11 of Auditing Standard No. 13.

J. Dual-purpose Test

Auditing Standard No. 13 recognized that, in certain situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction, i.e., a dual-purpose test. The auditor is required to design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. In addition, the auditor is required to evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested.[173/] The standard refers the auditors to the relevant requirements in AU sec. 350, *Audit Sampling*, for determining the proper sample size in a dual-purpose test.

VIII. <u>Auditing Standard No. 14 – Evaluating Audit Results</u>

A. Background

Auditing Standard No. 14 describes the auditor's responsibilities regarding the process of evaluating the results of the audit and determining whether sufficient appropriate audit evidence has been obtained in order to form the opinion to be expressed in the auditor's report. This standard consolidates into one auditing standard the requirements that were previously included in five separate auditing standards.[174/] The standard highlights matters that are important to the auditor's conclusions about the financial statements and the effectiveness of internal control.

B. Definition of Misstatement

The reproposed standard defined the term "misstatement" as follows:

> A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting

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[173/] Paragraph 47 of Auditing Standard No. 13.

[174/] AU sec. 312, regarding evaluating audit results, including uncorrected misstatements; AU sec. 316, regarding fraud considerations that are relevant to evaluating audit results; AU sec. 329, regarding performing the overall review; AU sec. 326, regarding determining whether sufficient appropriate audit evidence has been obtained; and AU sec. 431, regarding the evaluation of disclosures.

> framework.[175] A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework. Misstatements can arise from error (i.e., unintentional misstatement) or fraud.

Some commenters indicated that the definition applied to "material misstatement" rather than "misstatement" and suggested revisions to the definition, e.g., moving the second sentence to the beginning of the definition.

Auditing Standard No. 14 carries forward the definition of "misstatement" as reproposed.[176] This definition is not a definition of the term "material misstatement." Rather, the definition emphasizes that misstatements prevent financial statements from being fairly presented in conformity with the applicable financial reporting framework, as discussed in AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.* The phrase used in the definition, "if material individually or in combination with other misstatements," is equivalent to the phrase "In the absence of materiality considerations," which was used in the description of the term "misstatement" in an auditing interpretation of AU sec. 312.[177] The second sentence of the definition in Auditing Standard No. 14 describes the most common types of misstatements.[178]

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[175] The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

[176] Paragraph A2 of Appendix A to Auditing Standard No. 14.

[177] Paragraph .02 of AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312,* which is superseded by the risk assessment standards, stated "In the absence of materiality considerations, a misstatement causes the financial statements not to be in conformity with generally accepted accounting principles."

[178] See also paragraph A2 of Auditing Standard No. 14.

C. Performing Analytical Procedures in the Overall Review

Auditing Standard No. 14 adapted the requirements that were previously included in AU secs. 316 and 329 to read the financial statements and disclosures and perform analytical procedures in the overall review. The standard imposes on auditors a responsibility to read the financial statements and disclosures and perform analytical procedures to (a) evaluate the auditor's conclusions formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement.[179/] In particular, Auditing Standard No. 14 requires the auditor to evaluate whether (a) evidence gathered in response to unusual or unexpected transactions, events, amounts, or relationships previously identified during the audit is sufficient and (b) unusual or unexpected transactions, events, amounts, or relationships indicate risks of material misstatement that were not identified previously.[180/] Performing analytical procedures in the overall review assists the auditor in assessing the conclusions reached and in evaluating the overall financial statement presentation.

Auditing Standard No. 14 adapted a requirement, which previously existed in AU sec. 316, for the auditor to perform analytical procedures relating to revenue through the end of the period.[181/] These procedures are intended to identify unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including a material misstatement due to fraud. Performing analytical procedures relating to revenue is important in light of the generally higher risk of financial statement fraud involving revenue accounts.

Auditing Standard No. 14 requires the auditor to corroborate management's explanations regarding significant unusual or unexpected transactions, events, amounts, or relationships. The standard also states that if management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures to address the matter.[182/] Auditing Standard No. 15, *Audit Evidence,* states

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[179/] Paragraph 5 of Auditing Standard No. 14.

[180/] Paragraph 6 of Auditing Standard No. 14.

[181/] Paragraph 7 of Auditing Standard No. 14.

[182/] Paragraph 8 of Auditing Standard No. 14.

that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level.[183/] Therefore, obtaining corroboration of management's responses is important in obtaining sufficient appropriate audit evidence.

D. Clearly Trivial

Auditing Standard No. 14 requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial.[184/] Like AU sec. 312, the standard allows the auditor to set a threshold for accumulating misstatements, provided that the threshold is set at a de minimis level that could not result in material misstatement of the financial statements, individually or in combination with other misstatements, after considering the possibility of further undetected misstatement.[185/] The specific limitation on setting a threshold for accumulating misstatements is important to assure a proper evaluation of the effect of uncorrected misstatements on the financial statements.

E. Accumulating Misstatements

The reproposed standard required the auditor to accumulate identified misstatements other than those that are clearly trivial. The reproposed standard also required the auditor to use his or her best estimate of the total misstatement in the accounts and disclosures that the auditor has tested, not just the amount of misstatements specifically identified. This includes misstatements related to accounting estimates and projected misstatements from substantive procedures that involve audit sampling.[186/]

Commenters suggested that the standard should use terms such as "known and likely misstatement" or other terms to categorize the misstatements. Auditing Standard No. 14 uses the term "identified misstatement" to refer to misstatements that are identified during the audit and the term "accumulated misstatements" to refer to misstatements that are more than clearly trivial and, thus, should be accumulated by the auditor. Because Auditing Standard No. 14 requires the auditor to use his or her best

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183/ Paragraph 17 of Auditing Standard No. 15.

184/ Paragraph 10 of Auditing Standard No. 14.

185/ Paragraph 11 of Auditing Standard No. 14.

186/ Paragraphs 10-12 of Auditing Standard No. 14.

estimate of the misstatements (which is how AU sec. 312 described "likely misstatements"), it is not necessary to use the term "known and likely misstatements."

F. Correction of Misstatements

Auditing Standard No. 14 requires that if management made corrections to accounts or disclosures in response to misstatements detected by the auditor, the auditor should evaluate management's work to determine whether the corrections have been recorded properly and to determine whether uncorrected misstatements remain.[187/] The standard imposes on auditors a responsibility to determine whether misstatements identified by the auditor and communicated to management are correctly recorded in the accounting records.

G. Considerations When Accumulated Misstatements Approach the Materiality Level or Levels Used in Planning and Performing Audit Procedures

Auditing Standard No. 14 requires the auditor to determine whether the overall strategy needs to be revised when the aggregate of misstatements accumulated during the audit approaches the materiality level or levels used in planning and performing the audit. When the aggregate of misstatements approaches the materiality level or levels used in planning and performing an audit, there likely will be greater than an appropriately low level of risk that possible undetected misstatements, combined with uncorrected misstatements accumulated during the audit, could be material to the financial statements. If the auditor assesses this risk to be unacceptably high, he or she should perform additional audit procedures or determine that management has adjusted the financial statements so that the risk that the financial statements are materially misstated has been reduced to an appropriately low level.[188/]

The reproposed standard stated that when the aggregate of accumulated misstatements approaches the materiality used in planning and performing the audit, the auditor should perform additional procedures or determine that management has adjusted the financial statements so that the risk of material misstatement has been reduced to an appropriately low level. One commenter suggested that it is not clear what the additional procedures are and that more work is not always the answer. The

187/ Paragraph 16 of Auditing Standard No. 14.

188/ Paragraph 14 of Auditing Standard No. 14.

additional procedures that are necessary depend upon, among other things, the procedures performed by the auditor to date and the nature of the misstatements that were detected.

H. Requirement to Reevaluate the Materiality Level

Auditing Standard No. 11 includes a requirement to reevaluate the established materiality level or levels in certain circumstances. Auditing Standard No. 14 states that if the reevaluation of the materiality level or levels established in accordance with Auditing Standard No. 11 results in a lower amount for the materiality level or levels, the auditor should take into account that lower materiality level in the evaluation of uncorrected misstatements.[189/] The requirements are intended to prevent the auditor from incorrectly concluding that uncorrected misstatements are immaterial because he or she used outdated financial statement information. However, the standard does not allow the auditor to establish a higher level or levels of materiality when uncorrected misstatements exceed the initially established level or levels of materiality.

Reevaluating the established materiality level or levels prior to evaluating the effect of uncorrected misstatements will cause audit results to be evaluated based on the latest financial information.

I. Evaluating Uncorrected Misstatements

The reproposed standard stated that the auditor should evaluate the uncorrected misstatements in relation to accounts and disclosures and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors. The reproposed standard retained the provisions regarding qualitative factors that were included in an auditing interpretation to AU sec. 312,[190/] with some minor revisions to align the factors more closely to the terminology in the reproposed standard and to omit qualitative factors that apply only to nonissuers. A commenter indicated that the term "profitability," which is included in the qualitative factors in Appendix B, is not defined, and the commenter suggested including examples of profitability in the reproposed standard. Although this term is not explicitly defined in Auditing Standard No. 14, it should be familiar to auditors because the related auditing interpretation was issued in 2000. Auditing Standard No. 14 carries forward the requirements and the related list of

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189/ Paragraph 17 of Auditing Standard No. 14.

190/ AU secs. 9312.15-.17.

qualitative factors that are substantially the same as those in the auditing interpretation.[191/]

Auditing Standard No. 14 requires an evaluation of the effects of both uncorrected misstatements detected in prior years and misstatements detected in the current year that relate to prior years.[192/] The standard does not address how to evaluate the effects of prior period misstatements because that is an accounting and financial reporting matter. For example, the SEC staff has provided guidance in SEC Staff Accounting Bulletin ("SAB") Topic 1.N, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements,* on the effects of prior year misstatements when quantifying misstatements in the current year financial statements. This SAB provides the SEC staff's views regarding evaluating the quantitative and qualitative factors regarding the materiality of uncorrected misstatements and evaluating the effects of prior year misstatements.

Auditing Standard No. 14 states that the auditor cannot assume that an instance of error or fraud is an isolated occurrence and that the auditor should evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement.[193/] This procedure is important to inform the auditor's conclusions about whether the auditor's risk assessments remain appropriate and whether he or she has obtained sufficient appropriate evidence to support his or her opinion.

The reproposed standard included a requirement to evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement. A commenter suggested that this evaluation should be performed at the time the misstatement is identified. In the Board's view, it is not necessary to prescribe the timing for the evaluation of the nature and effects of misstatements on the risk assessments. However, performing this evaluation during the course of the audit could allow the auditor to make the necessary modifications to his or her planned audit procedures on a more timely basis.

[191/] AU sec. 9312 and paragraph 17 and Appendix B of Auditing Standard No. 14.

[192/] Paragraph 18 of Auditing Standard No. 14.

[193/] Paragraph 19 of Auditing Standard No. 14.

The reproposed standard required the auditor to evaluate whether identified misstatements might be indicative of fraud and, in turn, how they affect the auditor's evaluation of materiality and the related audit responses. This requirement is adapted from AU sec. 316.[194/] One commenter suggested that when there is an indicator of fraud, the requirement should make clear that clearly trivial misstatements may need to be evaluated to determine if they should be included in the accumulated misstatements. Like AU sec. 316, the requirement in the reproposed standard was phrased in terms of identified misstatements rather than accumulated misstatements because fraud of relatively small amounts can be material to the financial statements.

Auditing Standard No. 14 retains the requirement as reproposed.[195/] If an auditor detects a misstatement, he or she should evaluate whether the misstatement is indicative of fraud when deciding whether a misstatement is clearly trivial and thus does not warrant being included with accumulated misstatements. Additionally, in situations in which the auditor believes that a misstatement is or might be intentional and the effect on the financial statements could be material or cannot be readily determined, Auditing Standard No. 14 requires that the auditor perform procedures to obtain additional audit evidence to determine whether the fraud has occurred or is likely to have occurred. If the fraud has occurred or is likely to have occurred, the auditor is required to determine its effect on the financial statements and the auditor's report thereon.

J. Communication of Accumulated Misstatements to Management

The reproposed standard required the auditor to communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them. The reproposed standard also required the auditor to obtain an understanding of the reasons that management decided not to correct misstatements communicated by the auditor.

Some commenters suggested that the standard should specifically require the auditor to request management to correct the misstatements.

194/ AU sec. 316.75.

195/ Paragraph 20 of Auditing Standard No. 14.

Auditing Standard No. 14 retains the requirement as reproposed.[196/] It is not necessary to specifically require the auditor to request that management correct the misstatements because management has its own legal responsibilities in relation to the preparation and maintenance of the company's books, records, and financial statements. Section 13(i) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78m(i), requires the financial statements filed with the SEC to reflect all material correcting adjustments identified by the auditor.

K. Communication of Illegal Acts

Auditing Standard No. 14 requires the auditor to determine his or her responsibility under AU secs. 316.79-.82A, AU sec. 317, and Section 10A of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j-1, if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred.[197/]

L. Evaluating the Qualitative Aspects of the Company's Accounting Practices

Auditing Standard No. 14 requires the auditor to evaluate the qualitative aspects of the company's accounting practices, including potential bias in management's judgments regarding the amounts and disclosures in the financial statements.[198/]

Auditing Standard No. 14 also states that if the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. Also, the standard states that the auditor should evaluate whether the auditor's risk assessments, including, in particular, the assessment of fraud risks, and the related audit responses remain appropriate.[199/]

The reproposed standard included an example of management bias, which was based on observations from the Board's oversight activities. This example indicated that

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196/ Paragraphs 15 and 25 of Auditing Standard No. 14.

197/ Paragraph 23 of Auditing Standard No. 14.

198/ Paragraph 24 of Auditing Standard No. 14.

199/ Paragraph 26 of Auditing Standard No. 14.

when management identifies adjusting entries that offset misstatements identified by the auditor, the auditor should perform procedures to determine why the underlying misstatement was not identified previously. The auditor also should evaluate the implications on the integrity of management, and the auditor's risk assessments, including fraud risk assessments, and perform additional procedures as necessary to address the risk of further undetected misstatements. A commenter suggested using the phrase "identified misstatements other than those that are … clearly trivial" instead of "identified misstatements." The requirement has been revised to refer to misstatements accumulated by the auditor as required by paragraph 10 of Auditing Standard No. 14.[200/]

M. Assessment of Fraud Risks

The reproposed standard required the auditor to evaluate whether the accumulated results of auditing procedures and other observations affect the auditor's assessment of fraud risks made throughout the audit and whether the audit procedures need to be modified to respond to those risks.[201/] The reproposed standard included a reference to Appendix C, which listed matters that might affect the assessment of fraud risks. Appendix C stated that if the matters listed in the appendix are identified during the audit, the auditor should determine whether the assessment of fraud risks remains appropriate or needs to be revised. This requirement was included because the evaluation provides additional insight regarding the fraud risks and the potential need to perform additional procedures to support the opinion to be expressed in the auditor's report.

Some commenters indicated that the requirement in Appendix C seems to indicate that the auditor is required to determine if each item identified during the audit individually affects the assessment of fraud risks, which appears to be inconsistent with paragraph 28. Those commenters suggested revisions to the first sentence of Appendix C. After considering these comments, the first sentence of Appendix C has been revised to state that if the matters listed in the appendix are identified during the audit, the auditor should take into account these matters in the evaluation of the assessment of fraud risks, as discussed in paragraph 28.[202/]

[200/] Paragraph 25 of Auditing Standard No. 14.

[201/] Paragraph 28 of Auditing Standard No. 14.

[202/] Paragraph C1 of Appendix C to Auditing Standard No. 14.

One commenter suggested including in Appendix C specific procedures that the auditor could perform to evaluate fraud risk, such as evaluating journal entries with round numbers or amounts slightly below a specified threshold. This type of procedure could be appropriate for selecting journal entries for testing, but it is different in nature from the matters listed in Appendix C.

Auditing Standard No. 14 includes a requirement for the engagement partner to determine whether there has been appropriate communication with the other engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks.[203/] This requirement is adapted from the existing PCAOB standards.[204/]

N. Evaluating Financial Statement Disclosures

The reproposed standard included a requirement, adapted from AU sec. 431, for the auditor to evaluate whether the financial statements contain the required disclosures and, if the required disclosures are not included in the financial statements, to express a qualified or adverse opinion in accordance with AU sec. 508, *Reports on Audited Financial Statements*. The reproposed standard also stated that evaluation of disclosures includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth. These requirements were included in the reproposed standard because of the importance of disclosures to the fair presentation of financial statements.

Some commenters stated that the requirements regarding evaluation of disclosures should be qualified based on materiality considerations. Auditing Standard No. 14 states that the auditor should evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework, which is aligned with an analogous

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[203/] Paragraph 29 of Auditing Standard No. 14.

[204/] AU sec. 316.18.

requirement in AU sec. 508.41.[205/] AU sec. 411 discusses the concept of materiality regarding the auditor's opinion that financial statements are presented fairly.[206/]

Another commenter questioned whether the statement that "Evaluation of disclosures includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth" is a requirement. The statement in the reproposed standard, which is retained in Auditing Standard No. 14, explains that the scope of the auditor's required evaluation of the information disclosed in the financial statements includes matters such as the form, arrangement, and content of the financial statements.[207/]

O. Evaluating the Sufficiency and Appropriateness of Audit Evidence

The reproposed standard required the auditor to conclude on whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements. The reproposed standard also presented a list of factors that are relevant to the auditor's conclusion on whether sufficient appropriate audit evidence has been obtained. Consideration of the listed factors is essential to reaching an informed conclusion about whether sufficient appropriate audit evidence has been obtained. Accordingly, both the requirement and the list of factors contained in the reproposed standard have been retained.[208/]

A commenter suggested that corrected adjustments also should be considered in concluding whether sufficient appropriate audit evidence has been obtained. Auditing Standard No. 14 already requires the auditor to evaluate the results of audit procedures in evaluating whether sufficient appropriate evidence has been obtained, and this would include misstatements identified by the auditor, regardless of whether they were corrected by management.[209/]

205/ Paragraph 31 of Auditing Standard No. 14.

206/ AU sec. 411.04.

207/ Paragraph 31 of Auditing Standard No. 14.

208/ Paragraphs 33-34 of Auditing Standard No. 14.

209/ Paragraph 34 of Auditing Standard No. 14.

The reproposed standard expanded the requirements regarding situations in which the auditor has not obtained sufficient appropriate audit evidence to include situations in which the auditor has substantial doubt about a relevant assertion. This additional provision was adapted from AU sec. 326. A commenter suggested that the requirement be revised to state that the auditor should attempt to obtain additional evidence if the auditor has not obtained sufficient appropriate evidence about a relevant assertion. The requirement has been retained as stated in the reproposed standard because it covers situations in which the evidence is inadequate and situations in which the auditor has concerns about whether an assertion is misstated.[210/]

P. Evaluating the Results of the Audit of Internal Control

The reproposed standard included a section relating to evaluating audit results in the audit of internal control, which references Auditing Standard No. 5 for the requirements on evaluating the results of the audit of internal control.[211/] A commenter suggested removing this paragraph from the reproposed standard. Auditing Standard No. 14 retains this paragraph, although it does not impose additional requirements. Including this paragraph emphasizes that, in integrated audits, the evaluation of audit results is an integrated process that affects both audits.

IX. Auditing Standard No. 15 – Audit Evidence

A. Background

Auditing Standard No. 15 explains what constitutes audit evidence, establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence to support the opinion in the auditor's report, and discusses methods for selecting items for testing.

B. Nature of Audit Evidence

The reproposed standard stated that audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions

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210/ Paragraph 35 of Auditing Standard No. 14.

211/ Paragraph 37 of Auditing Standard No. 14.

regarding the financial statements or internal control over financial reporting and any information that contradicts such assertions.

One commenter indicated that the meaning of the phrase "and any information that contradicts such assertions" was unclear. The commenter suggested that the Board clarify whether the requirement meant the auditor should look for such contradictory information, or if the requirement should apply only when such information comes to the auditor's attention.

PCAOB standards require the auditor to plan and perform the audit to obtain sufficient appropriate evidence to support an opinion about whether the financial statements are free of material misstatement and, in the audit of internal control, whether material weaknesses exist.[212/] Thus, the auditor is required to perform the audit procedures necessary to test the accounts and controls, regardless of whether the results of those procedures support or contradict the assertions. The requirement in Auditing Standard No. 15 means that when contradictory evidence is obtained, the auditor should evaluate it when forming a conclusion on the financial statements and, in integrated audits, on internal control over financial reporting. To clarify the requirement, Auditing Standard No. 15 omits the word "any."[213/]

C. Objective

The objective in the reproposed standard acknowledged the auditor's responsibility to plan and perform the audit to obtain sufficient appropriate audit evidence to support the opinion expressed in the auditor's report. Commenters suggested revising the wording in paragraph 4 of the reproposed standard to be consistent with the objective in paragraph 3 of the reproposed standard. The requirement in paragraph 4 of Auditing Standard No. 15 has been revised to be consistent with the objective of the standard.

D. Sufficient Appropriate Audit Evidence

The reproposed standard explained the meaning of the words "sufficient" and "appropriate" as used in the phrase "sufficient appropriate audit evidence." Commenters suggested that the Board provide formal definitions for terms like "sufficiency" and

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212/ Paragraph 3 of Auditing Standard No. 8 and paragraph 3 of Auditing Standard No. 5, respectively.

213/ Paragraph 2 of Auditing Standard No. 15.

"appropriate" so the terms can be easily located within the standards. Adding definitions is unnecessary because Auditing Standard No. 15 already describes the terms "sufficiency" and "appropriateness" and explains the relevant characteristics of each.[214/]

Commenters stated that the term "persuasive" was used in the reproposed standard, *The Auditor's Responses to the Risks of Material Misstatement,* and recommended that the Board clarify in the reproposed audit evidence standard the manner in which the persuasiveness of evidence affects the evaluation of audit evidence. The concept of "persuasiveness of evidence" is discussed in Auditing Standard No. 13.[215/]

E. Relevance and Reliability

The reproposed standard contained a discussion about the relevance and reliability of audit evidence. The reproposed standard stated that the audit evidence must be both relevant and reliable to support the auditor's conclusions about the subject of the audit procedure. The reproposed standard stated that "[e]vidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized, or otherwise converted into electronic form, the reliability of which depends on the controls over the conversion and maintenance of those documents."

One commenter suggested that the standard be revised to indicate that electronic information, subject to proper controls, is in many ways more reliable than physical documentation. The language from the reproposed standard was retained in Auditing Standard No. 15.[216/] Although evidence sometimes is available only in electronic form and the reliability of electronic evidence depends on the controls over that information, an authentic original document generally is more reliable than an electronic form of that document.

The reproposed standard stated that the relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The relevance of audit evidence depends on (a) the design of the audit procedure used to test the assertion or control, and (b) the timing of the audit procedure used to test the

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[214/] Paragraphs 5-6 of Auditing Standard No. 15.

[215/] Paragraph 39 of Auditing Standard No. 13.

[216/] Paragraph 8 of Auditing Standard No. 15.

assertion or control. One commenter recommended the description of the term "relevance" should be expanded to include the following statements:

> Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, when appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing.

Auditing Standard No. 15 retains the description included in the reproposed standard because it is clearer than the suggested revision.[217/]

The reproposed standard indicated that "[t]he auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should evaluate the effect, if any, on the other aspects of the audit."

One commenter suggested that the requirement for the auditor to modify the planned audit procedures or perform additional audit procedures in response to concerns about the authenticity of documents should be linked to professional skepticism. The commenter also stated that many modifications are routine. The requirement was not meant to require the auditor to perform unlimited procedures but, rather, to perform the procedures necessary to address the issue in the circumstances. Auditing Standard No. 15 retains this requirement as reproposed.[218/] Although professional skepticism is important in these situations, it is not the only factor that determines the procedures necessary to address the matter.

F. Financial Statement Assertions

In representing that the financial statements are presented fairly in conformity with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of financial statements and related disclosures. Financial statement assertions are an important consideration for audits performed in accordance with PCAOB standards. For example, AU sec. 319 required auditors to perform

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[217/] Paragraph 7 of Auditing Standard No. 15.

[218/] Paragraph 9 of Auditing Standard No. 15.

substantive procedures for relevant assertions in audits of financial statements. Auditing Standard No. 5 requires auditors to obtain evidence about the design and operating effectiveness of controls over relevant assertions in audits of internal control.

The reproposed standard retained the five categories of financial statement assertions in AU sec. 326 and Auditing Standard No. 5. Two commenters suggested that the Board use different descriptions for financial statement assertions. One commenter suggested using other standard-setters' descriptions of financial statement assertions. The other commenter suggested using a different description of assertions. Auditing Standard No. 15 retains the categories of assertions as reproposed.[219/] Like Auditing Standard No. 5,[220/] Auditing Standard No. 15 allows auditors the flexibility to use categories of assertions that differ from the assertions listed in the standard under specified conditions.[221/]

G. Inquiry

The reproposed standard stated that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control. One commenter suggested that the note to paragraph 17 of the reproposed standard be revised to include "design and operating effectiveness of a control" and that the auditor should perform audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Auditing Standard No. 15 retains the language from the reproposed standard. The phrase "effectiveness of a control" encompasses both design and operating effectiveness. It is not considered necessary to add that the auditor should perform additional procedures, since Auditing Standard No. 15 states that inquiry, by itself, does not provide sufficient audit evidence.[222/]

219/ Paragraph 11 of Auditing Standard No. 15.

220/ See the note to paragraph 28 of Auditing Standard No. 5.

221/ Paragraph 12 of Auditing Standard No. 15.

222/ Paragraph 17 of Auditing Standard No. 15.

H. Confirmation

The reproposed standard stated that a confirmation represents audit evidence obtained by the auditor as a direct response to the auditor from a third party. Some commenters suggested that the reproposed standard clarify that a confirmation be written. Auditing Standard No. 15 has been revised to state that a confirmation response represents a particular form of audit evidence obtained by the auditor from a third party in accordance with PCAOB standards.[223/] The Board has a separate standards-setting project on confirmations that, among other things, will address the use of written confirmation or other alternative forms of confirmation.[224/]

I. Analytical Procedures

The reproposed standard described analytical procedures as an audit procedure for obtaining evidence. One commenter suggested adding "scanning" as part of analytical procedures. Scanning is a means for selecting items for testing, not a separate audit procedure. The description of analytical procedures in Auditing Standard No. 15 is retained as reproposed.[225/]

J. Selecting Items for Testing to Obtain Audit Evidence

Auditing Standard No. 15 contains a section on selecting items for testing that is adapted from an auditing interpretation of AU sec. 350.[226/] The standard also states that the auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure.[227/]

The reproposed standard defined audit sampling as the application of an audit procedure to less than 100 percent of the occurrences of a control or items comprising

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[223/] Paragraph 18 of Auditing Standard No. 15.

[224/] PCAOB Release No. 2010-003, *Proposed Auditing Standard Related to Confirmation and Related Amendments to PCAOB Standards* (July 13, 2010).

[225/] Paragraph 21 of Auditing Standard No. 15.

[226/] AU sec. 9350, *Audit Sampling: Auditing Interpretations of AU sec. 350.*

[227/] Paragraph 22 of Auditing Standard No. 15.

an account for the purpose of evaluating some characteristic of the control or account. One commenter stated that the definition in the standard should be conformed to AU sec. 350. Auditing Standard No. 15 reflects revisions that align the standard with AU sec. 350.

K. Other Changes

As noted in the reproposing release, certain topics that were included in AU sec. 326 were not carried forward to the reproposed standard and Auditing Standard No. 15. AU sec. 326 discussed the use of audit objectives, and an appendix to that standard illustrated how auditors might use assertions to develop audit objectives and substantive tests of inventory. Such a discussion is not necessary because the auditing standards do not require auditors to establish audit objectives to link assertions to substantive procedures. However, omission of this discussion would not preclude auditors from using audit objectives in designing their audit procedures.

X. Amendments to PCAOB Standards

A. Amendments to Auditing Standard No. 3

In the release accompanying the original proposed standards, the Board sought comment on the need for specific documentation requirements regarding the risk assessment procedures. Responses from commenters were mixed. Some commenters supported adding specific documentation requirements, other commenters stated that the requirements in Auditing Standard No. 3, *Audit Documentation,* were adequate, and one commenter was ambivalent.

After consideration of these comments and additional analysis, the amendments accompanying the reproposed standards included certain amendments to Auditing Standard No. 3 to (a) specify certain required documentation regarding the auditor's risk assessments and related responses, (b) align certain terms and provisions of Auditing Standard No. 3 with the risk assessment standards, and (c) incorporate the principles for documentation of disagreements among engagement team members. For example, the amendments indicated that the auditor's documentation should include the following:

1. A summary of the identified risks of misstatement and the auditor's assessment of risks of material misstatement at the financial statement and assertion levels; and

2. The auditor's responses to the risks of material misstatement, including linkage of the responses to those risks.

Also, the requirements regarding documentation of significant findings or issues and related matters were expanded to require documentation regarding the significant risks identified and the results of the auditing procedures performed in response to those risks.

A commenter indicated that the additional documentation requirement will result in "unnecessary linkage" and "a matrix-like mentality" to the audit documentation. The documentation requirements are intended to enhance the auditor's ability to link identified and assessed risks to appropriate responses and could help reviewers understand the areas of greatest risk and the auditor's responses to those risks. In addition to these documentation requirements, the auditor would continue to be responsible for preparing documentation as required by other provisions of Auditing Standard No. 3, e.g., to demonstrate that the engagement complied with the standards of the PCAOB.[228/]

Some commenters suggested placing the documentation requirements in the respective risk assessment standards rather than amending Auditing Standard No. 3. The risk assessment standards are foundational standards; therefore, the required documentation related to the risk assessment standards is included in Auditing Standard No. 3.[229/] Future decisions about the placement of new documentation requirements will be made during the course of the respective standards-setting projects.

B. Amendments to Auditing Standard No. 4

The amendment to Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist,* is limited to changing the word "competent" to "appropriate" when that word is used in reference to audit evidence.

C. Amendments to Auditing Standard No. 5

The amendments to Auditing Standard No. 5 that accompanied the reproposed standards were limited to changing the phrase "any assistants" to "the members of the

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228/ Paragraph 5.a. of Auditing Standard No. 3.

229/ Paragraphs 9, 12, and 19 of Auditing Standard No. 3, as amended.

engagement team," changing the word "competent" to "appropriate" when that word is used in reference to audit evidence, and updating references to auditing standards that are being superseded or amended. These amendments are retained as reproposed.

One commenter suggested a series of additional amendments to Auditing Standard No. 5, which primarily involved removing certain paragraphs from Auditing Standard No. 5 that relate to risk assessment procedures or other requirements that are included in the risk assessment standards. The Board is not removing the requirements regarding risk assessment procedures from Auditing Standard No. 5 because those requirements are important to understanding the other provisions of Auditing Standard No. 5 for performing an audit of internal control.

D. Amendments to Auditing Standard No. 6

The amendments to Auditing Standard No. 6, *Evaluating Consistency of Financial Statements,* are limited to removing a footnote stating that the term "error" as used in Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("SFAS No. 154"), is equivalent to "misstatement" as used in the auditing standards and updating a reference to a standard that is being superseded. This technical change is made because the footnote regarding misstatements in Auditing Standard No. 6 refers to SFAS No. 154, whereas the definition of "misstatement" in Auditing Standard No. 14 on evaluating audit results is neutral regarding the financial reporting framework. However, this technical change does not alter the fact that an error under accounting standards generally accepted in the United States is a misstatement under Auditing Standard No. 14.

E. Amendments to Auditing Standard No. 7

The amendments to Auditing Standard No. 7, *Engagement Quality Review,* update footnote 3 and the note to paragraph 10 to replace a reference to an interim standard that is superseded and to update the definitions of the terms "engagement partner" and "significant risk" to conform to the definitions in the risk assessment standards.

F. Amendments to Interim Auditing Standards

1. Superseded Sections

The risk assessment standards supersede the following sections of PCAOB interim auditing standards:

- AU sec. 311, *Planning and Supervision*
- AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*
- AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date*
- AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*
- AU sec. 326, *Evidential Matter*
- AU sec. 431, *Adequacy of Disclosure in Financial Statements*

Similarly, the auditing interpretations of AU secs. 311, 312, and 350 have been incorporated into the risk assessment standards and thus are superseded. The auditing interpretations of AU sec. 326, except for Interpretation No. 2 (AU secs. 9326.06-.23), also are superseded.[230/]

2. AU sec. 316, Consideration of Fraud in a Financial Statement Audit

The relevant requirements regarding identifying and assessing fraud risks, principally AU secs. 316.14-.45; responding to fraud risks, principally AU secs. 316.46-.50; and evaluating audit results, principally AU secs. 316.68-.78, have been incorporated into Auditing Standard Nos. 12, 13, and 14, respectively. The remaining portions of AU sec. 316 describe important principles regarding the auditor's responsibility with respect to fraud and more detailed requirements regarding the auditor's responses to fraud risks. Topics covered in the remaining portions of AU sec. 316, as amended, include the following:

- A description of fraud and its characteristics,
- The importance of exercising professional skepticism,
- Examples of fraud risk factors,

[230/] Interpretation No. 2 relates in part to AU sec. 336 and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments,* and it will be evaluated in connection with standards-setting projects related to those standards.

- Examples of audit procedures performed to respond to fraud risks involving fraudulent financial reporting and misappropriation of assets, and

- Requirements regarding procedures to further address the risk of material misstatement due to fraud involving management override of controls, including examining journal entries and other adjustments for evidence of possible material misstatement due to fraud; reviewing accounting estimates for biases that could result in material misstatement due to fraud; and evaluating the business rationale for significant unusual transactions.

3. AU sec. 329, Analytical Procedures

The discussion in AU sec. 329 regarding analytical procedures performed during audit planning, principally AU secs. 329.03 and 329.06-.08, is incorporated into Auditing Standard No. 12. Similarly, the requirements regarding analytical procedures in the overall review, principally AU secs. 329.23-.24, are incorporated into Auditing Standard No. 14. The remaining portion of AU sec. 329 relates to analytical procedures performed as substantive procedures. Therefore, AU sec. 329 is retitled, *Substantive Analytical Procedures,* which more accurately reflects the content of the amended standard.

A standard that focuses solely on substantive analytical procedures highlights more clearly the requirements that apply to analytical procedures performed for that purpose, including, the higher degree of precision in substantive analytical procedures needed to provide the necessary level of assurance. The Board has observed instances in which auditors performed substantive procedures to test accounts without meeting the requirements in AU sec. 329 for substantive analytical procedures.[231/]

4. AU sec. 336, *Using the Work of a Specialist*

The text of footnote 1 to paragraph .01 and of paragraph .05 were amended to clarify that AU sec. 336 does not apply to situations in which persons who participate in the audit have specialized skills or knowledge in accounting or auditing (e.g., IT specialists and income tax specialists) and to specialists employed by the firm. Auditing

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[231/] See, e.g., PCAOB Release 2007-010, *Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms* (October 22, 2007).

Standard No. 10 applies to those situations. Those clarifications were previously included in the reproposed standard on audit planning and supervision.

5. AU sec. 350, Audit Sampling

The discussion in AU sec. 350 regarding audit risk and tolerable misstatement has been amended to align more closely with the terminology used in the risk assessment standards.

The reproposed standards included amendments to AU secs. 350.23 and 350.38, which explained more specifically the principles in the standard for determining sample sizes when nonstatistical sampling approaches are used. Some commenters expressed concern that the reproposed amendments would have required auditors who use nonstatistical sampling methods to compute sample sizes under both statistical and nonstatistical methods to demonstrate that the sample size under the nonstatistical method equaled or exceeded the sample size determined using a statistical method.

Commenters suggested that the standard should state that it is not necessary to compute sample sizes using statistical methods. Including such a sentence in the standard might be misunderstood by auditors and weaken the requirement of the amended standard. The reproposed amendments do not require auditors to compute sample sizes using statistical methods in all instances to demonstrate compliance with the requirements. For example, the use of a nonstatistical sampling methodology that is adapted appropriately from a statistical sampling method also could demonstrate compliance. However, calculating a sample size that is not based on the relevant factors in AU sec. 350 is not in compliance with the standard. Accordingly, the amendments are retained as reproposed.

6. AU sec. 543, Part of Audit Performed by Other Independent Auditors, and interpretations

A note was added to paragraph .01 to clarify that Auditing Standard No. 10 applies to situations not covered by AU sec. 543 in which the auditor engages other accounting firms or other accountants to participate in the audit. Paragraph .12 was amended to align AU sec. 543 with related amendments to Auditing Standard No. 3. Footnote 4 to paragraph .16 of AU sec. 9543*, Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543,* is deleted because it refers to an interim standard that is being superseded.

7. *Other Amendments to the Interim Auditing Standards*

For the following interim auditing standards, the amendments are limited to conforming terminology to the risk assessment standards and updating references to auditing standards that are being superseded or amended:

- AU sec. 110, *Responsibilities and Functions of the Independent Auditor*
- AU sec. 150, *Generally Accepted Auditing Standards*
- AU sec. 210, *Training and Proficiency of the Independent Auditor*
- AU sec. 230, *Due Professional Care in the Performance of Work*
- AU sec. 310, *Appointment of the Independent Auditor*
- AU sec. 315, *Communications Between Predecessor and Successor Auditors*
- AU sec. 317, *Illegal Acts by Clients*
- AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.
- AU sec. 324, *Service Organizations*
- AU sec. 328, *Auditing Fair Value Measurements and Disclosures*
- AU sec. 330, *The Confirmation Process*
- AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*
- AU sec. 333, *Management Representations*
- AU sec. 334, *Related Parties,* and AU sec. 9334, *Related Parties: Auditing Interpretations of Section 334*
- AU sec. 9336, *Using the Work of a Specialist: Auditing Interpretations of Section 336*

- AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
- AU sec. 342, *Auditing Accounting Estimates*, and AU sec. 9342, *Auditing Accounting Estimates: Auditing Interpretations of Section 342*
- AU sec. 380, *Communication With Audit Committees*
- AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*
- AU sec. 508, *Reports on Audited Financial Statements,* and AU sec. 9508, *Reports on Audited Financial Statements: Auditing Interpretations of Section 508*
- AU sec. 530, *Dating of the Independent Auditor's Report*
- AU sec. 722, *Interim Financial Information*

G. Amendments to Interim Ethics Standards

In the interim ethics standards, ET sec. 102, *Integrity and Objectivity,* the amendments are limited to updating references to auditing standards that are being superseded or amended.

XI. Other Topics Not Related to the Reproposed Standards

The comment letters on the reproposed standards included certain comments that relate to standards-setting matters other than the reproposed standards. The following paragraphs discuss those comments.

A. Comparison with the Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

In developing its original proposed standards, the Board took into account, among other things, the risk assessment standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board of the American Institute of Certified Public Accountants ("ASB"). The release accompanying the reproposed standards included a comparison of the objectives and requirements of the reproposed standards to the analogous standards of the IAASB and ASB.

Some commenters requested additional details about differences between the reproposed standards and the IAASB or ASB standards or clarifications regarding specific requirements in the reproposed standards for which the language was not identical to IAASB or ASB standards.

In analyzing comments on the appendix to the reproposed standards that compared the reproposed standards to the analogous standards of the IAASB and ASB, the Board observed that a number of the explanations sought by commenters, e.g., the reasons for the differences in certain requirements were discussed elsewhere in the release accompanying the reproposed standards, e.g., in Appendix 9 to that release, which is analogous to this appendix (Appendix 10) to this release.

This appendix provides the principal discussion of the rationale for the objectives and requirements in the Board's standards. Appendix 11 of this release discusses certain differences between the objectives and requirements of the PCAOB standards and the analogous standards of the IAASB and ASB. When a difference between the Board's standards and the analogous standards of the IAASB and ASB is noted, Appendix 11 contains a reference to the discussion of the Board's requirements in this appendix (Appendix 10).

B. Standards-setting Process

Some commenters suggested changes to the Board's standards-setting process. These comments primarily relate to the extent to which the Board uses the standards of the IAASB and ASB in its standards-setting and the use of external task forces in drafting standards.

In previous releases on its proposed risk assessment standards, the Board has stated that it has sought to eliminate unnecessary differences with the risk assessment standards and those of other standards-setters. However, because the Board's standards must be consistent with the Board's statutory mandate,[232/] differences will continue to exist between the Board's standards and the standards of the IAASB and ASB e.g., when the Board decides to retain an existing requirement in PCAOB

[232/] E.g., Section 101 of the Sarbanes-Oxley Act of 2002 (the "Act"), 15 U.S.C. § 7211.

standards that is not included in IAASB or ASB standards. Also, certain differences are often necessary for the Board's standards to be consistent with relevant provisions of the federal securities laws or other existing standards or rules of the Board. Also, the Board's standards-setting activities are informed by and developed to some degree, in response to observations from its oversight activities.

The Board has a number of means available to seek additional comments from external parties regarding its standards-setting activities, including meetings with its Standing Advisory Group ("SAG"), issuing concept releases or reproposing standards or rules, and conducting public roundtables. Although these are not the only means available to the Board, they have been used because they offer the Board the ability to obtain comments from a diverse group of interested parties through a public process.

The Board continually endeavors to improve its processes, including its standards-setting process, and considers comments from the public as it does so. For example, the Board has undertaken certain steps to enhance the transparency of its standards-setting process, including maintaining on its Web site its standards-setting agenda and discussing the status of projects in public meetings with the SAG. This release has also been expanded to provide additional discussion of and explanation for the Board's conclusions regarding the risk assessment standards. Some commenters acknowledged the Board's efforts to increase the transparency of its process.

C. Other Standards-setting Projects

Commenters on the reproposed standards also recommended a number of additional standards-setting or standards-related projects for the Board. Examples of such projects included creating a codification of the Board's standards; creating a glossary of terms used in the Board's standards, issuing a concept release for the review of the Board's interim standards, developing a standard describing the overall objectives of the audit, similar to ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,* and developing guidance related to how the Board would evaluate the reasonableness of judgments based on PCAOB auditing standards.

The Board continually assesses its standards-setting and related projects based upon the need for improvements in standards or additional guidance in response to current developments, observations from the Board's oversight activities, comments received from the public, and other factors. As mentioned previously, the Board's standards-setting agenda is maintained on the Board's website. The Board is considering these comments as it assesses its agenda.

APPENDIX 11

Comparison of the Objectives and Requirements of the Accompanying PCAOB Auditing Standards with the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

This appendix discusses certain differences between the objectives and requirements of the PCAOB auditing standards accompanying this release and the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the analogous clarified or proposed standards of the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA"). This analysis does not cover the application and explanatory material in the IAASB standards or the ASB standards.[1/]

This appendix is provided for informational purposes only. It is not a substitute for the PCAOB auditing standards themselves, which are presented in Appendices 1-8 of this release and discussed further in Appendix 10.

Appendix 10 to this release provides the principal discussion of the rationale for the objectives and requirements in the Board's standards. Thus, this appendix includes cross-references to the relevant explanation of the PCAOB requirements.

This analysis may not represent the views of the IAASB or ASB regarding their standards.

Auditing Standard No. 8 – Audit Risk

Analogous discussions of the components of audit risk are included in the IAASB's International Standard on Auditing ("ISA") 200, *Overall Objectives of the*

[1/] Paragraph A59 of ISA 200 states that the Application and Other Explanatory Material section of the ISAs "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA." Paragraph A63 of the SAS, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, states that although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU section."

Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing and the ASB's clarified Statement on Auditing Standards ("SAS"), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards,* respectively.

1. Audit Risk and Reasonable Assurance

PCAOB

Auditing Standard No. 8 states that to form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.[2/]

Auditing Standard No. 8 uses the phrase "appropriately low level" because the term "appropriately" is aligned more closely with the concept of reasonable assurance whereas "acceptable level" might be misunderstood as allowing auditors to vary the audit efforts based upon their personal tolerance for risk. Appendix 10 provides additional discussion regarding the use of the phrase "appropriately low level."[3/]

Auditing Standard No. 8 also clarifies that obtaining sufficient appropriate audit evidence is part of applying due professional care. Appendix 10 provides additional discussion regarding due professional care and sufficient appropriate audit evidence.[4/]

IAASB and ASB

The ISA states:

> To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low

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[2/] AU sec. 110, *Responsibilities and Functions of the Independent Auditor,* and AU sec. 230, *Due Professional Care in the Performance of Work,* provide further discussion of reasonable assurance.

[3/] Section II.B. of Appendix 10.

[4/] Section II.C. of Appendix 10.

level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

The SAS includes a requirement similar to the ISA's requirement.

2. Detection Risk and Substantive Procedures

PCAOB

Auditing Standard No. 8 states that as the appropriate level of detection risk decreases, the evidence from substantive procedures that the auditor should obtain increases. This requirement was adapted from AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*,[5/] and it parallels a requirement in Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.[6/] Appendix 10 provides additional discussion regarding detection risk.[7/]

IAASB and ASB

The ISA and the SAS do not include an analogous requirement.

Auditing Standard No. 9 – Audit Planning

In this section, the analogous IAASB and ASB standards are, unless indicated otherwise, ISA 300, *Planning an Audit of Financial Statements,* and the clarified SAS, *Planning an Audit,* respectively.

1. Planning an Audit

PCAOB

Auditing Standard No. 9 contains a requirement to properly plan the audit. This requirement is consistent with the first standard of fieldwork in AU sec. 150, *Generally Accepted Auditing Standards.*

5/ AU sec. 319 is superseded by the risk assessment standards.

6/ Paragraph 37 of Auditing Standard No. 13.

7/ Section II.E. of Appendix 10.

IAASB and ASB

The ISA and the SAS do not include an analogous requirement, although planning the audit is referenced in the objectives of the standards.

2. Audit Strategy and Audit Plan

PCAOB

Auditing Standard No. 9 requires the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan. When developing the audit strategy and audit plan, the standard requires the auditor to evaluate whether certain matters specified in the standard are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures As discussed in Appendix 10, these matters are adapted from Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and are important for both the audit of financial statements and an audit of internal control over financial reporting ("audit of internal control").[8/]

In establishing the overall audit strategy, Auditing Standard No. 9 also requires the auditor to take into account certain matters, such as the reporting objectives and the factors that are significant in directing the activities of the engagement team, results of preliminary engagement activities and the auditor's evaluation of the important matters in accordance with paragraph 7, and the nature, timing, and extent of resources necessary to perform the engagement. Appendix 10 discusses this requirement with more detail.[9/]

Auditing Standard No. 9 requires the auditor to develop and document an audit plan that includes a description of the planned nature, timing, and extent of risk assessment procedures; tests of controls, substantive procedures, and other audit procedures. The audit plan required by Auditing Standard No. 9 encompasses all of the audit procedures to be performed, i.e., it is not limited to procedures at the assertion

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8/ Section III.E. of Appendix 10.

9/ Section III.F. of Appendix 10.

level. Appendix 10 provides additional discussion regarding developing the audit strategy and audit plan.[10/]

IAASB and ASB

The ISA and the SAS require the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan. Those standards do not have a requirement analogous to the Auditing Standard No. 9 requirement to evaluate specific matters in developing the audit strategy and audit plan.

The ISA states:

> In establishing the overall audit strategy, the auditor shall:
>
> (a) Identify the characteristics of the engagement that define its scope;
>
> (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
>
> (c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
>
> (d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
>
> (e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

The SAS includes a requirement similar to the ISA's requirement.

Both the ISA and the SAS require the auditor to develop an audit plan that shall include a description of the nature, timing, and extent of planned further auditor procedures at the assertion level.

10/ Ibid.

3. Multi-location Engagements

PCAOB

Auditing Standard No. 9 states that the auditor should determine the extent to which auditing procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the audit procedures to be performed at those individual locations or business units. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit. Auditing Standard No. 9 also provides a list of factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures.

The provisions in Auditing Standard No. 9 are applicable to all multi-location audits. Appendix 10 discusses the basis for the requirements and explains how the requirements should be applied in audits in which part of the work is performed by other auditors of financial statements of individual locations or business units that are included in the consolidated financial statements.[11/]

IAASB and ASB

ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors),* and the proposed SAS, *Audits of Group Financial Statements (Including the Work of Component Auditors),* apply to group audits. Under ISA 600, group audits are defined as the audit of group financial statements, which are financial statements that include the financial information of more than one component, and the component auditor is an auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

[11/] Section III.G. of Appendix 10.

ISA 600 and the proposed SAS describe the scope of audit procedures to be performed at individual components, depending upon, among other things, whether the components are significant components as described in the respective standards.

Auditing Standard No. 10 – Supervision of the Audit Engagement

In this section, unless indicated otherwise, the analogous IAASB standards are ISA 300, *Planning an Audit of Financial Statements,* and ISA 220, *Quality Control for an Audit of Financial Statements,* (collectively referred to in this section as "the ISAs"); and the analogous ASB standards are the clarified SAS, *Planning an Audit,* and the proposed SAS, *Quality Control for an Audit of Financial Statements,* (collectively referred to in this section as "the SASs").

1. Supervision

PCAOB

Auditing Standard No. 10 states that the engagement partner is responsible for supervising other engagement team members and may seek assistance from appropriate engagement team members. Auditing Standard No. 10 also requires the engagement partner, and engagement team members who assist the engagement partner in supervision, to properly supervise the members of the engagement team, describes the necessary elements of proper supervision, and describes the factors that affect the necessary extent of supervision. These requirements are adapted from AU sec. 311, *Planning and Supervision.*[12/] Appendix 10 provides additional discussion regarding these requirements.[13/]

The requirements in the ISAs and the SASs do not describe the elements of supervision or factors that affect supervision.

IAASB and ASB

The ISAs and the SASs require the auditor to plan the nature, timing, and extent of direction and supervision of engagement team members and review their work. The ISAs and SASs require the engagement partner to "take responsibility for the direction,

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[12/] AU sec. 311 is superseded by Auditing Standard No. 9 and Auditing Standard No. 10.

[13/] Section IV.D. of Appendix 10.

supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements and for the auditor's report being appropriate in the circumstances."

2. Supervision of Engagement Team Members

PCAOB

Auditing Standard No. 10 requires the engagement partner and other engagement team members performing supervisory activities to: (a) inform engagement team members of their responsibilities, including the objectives of the procedures that they are to perform; the nature, timing and extent of procedures they are to perform; and matters that could affect the procedures to be performed or the evaluation of the results of those procedures, (b) direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervising activities, and (c) review the work of engagement team members to evaluate whether the work was performed, the objectives of the procedures were achieved, and the results of the work support the conclusions. Appendix 10 provides additional discussion regarding this requirement.[14/]

IAASB

The ISAs state:

> The engagement partner shall take responsibility for:
>
> (a) The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory and legal requirements; and
>
> (b) The auditor's report being appropriate in the circumstances.
>
> The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures.

[14/] Section IV.E. of Appendix 10.

> On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.
>
> The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

ASB

The SAS includes requirements similar to the ISAs' requirements.

3. Extent of Supervision

PCAOB

To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, Auditing Standard No. 10 requires the engagement partner and other engagement team members performing supervisory activities to take into account the nature of company, the nature of the assigned work for each team member, the risks of material misstatement, and the knowledge, skill, and ability of each engagement team member. Appendix 10 provides additional discussion regarding this requirement.[15/]

IAASB and *ASB*

The ISAs and SASs do not have an analogous requirement for the auditor to determine the extent of supervision necessary for engagement team members.

Auditing Standard No. 11 – Consideration of Materiality in Planning and Performing an Audit

In this section, the analogous IAASB and ASB standards are ISA 320, *Materiality in Planning and Performing an Audit,* and the clarified SAS, *Materiality in Planning and Performing an Audit*, and the proposed SAS, *Audits of Group Financial Statements (Including the Work of Component Auditors),* respectively.

[15/] Ibid.

1. Definition of Materiality

PCAOB

Auditing Standard No. 11 requires the auditor to establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances, including consideration of the company's earnings and other relevant factors. The requirement in Auditing Standard No. 11 is based on the concept of materiality that is articulated by the courts in interpreting the federal securities laws. Appendix 10 discusses the concept of materiality used in Auditing Standard No. 11.[16/]

IAASB and ASB

The ISA states, "When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole."

The SAS has a requirement similar to the ISA's requirement.

2. Materiality in the Context of an Audit

PCAOB

Auditing Standard No. 11 requires the auditor to plan and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements in order to obtain reasonable assurance about whether the financial statements are free of material misstatement. Appendix 10 discusses the concept of materiality in the context of an audit.[17/]

IAASB

ISA 200 states:

> In conducting an audit of financial statements, the overall objectives of the auditor are:

[16/] Section V.B. of Appendix 10.

[17/] Ibid.

a. To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

b. To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.

ASB

The SAS includes an objective similar to the ISA's objective.

3. Tolerable Misstatement and Performance Materiality

PCAOB

Auditing Standard No. 11 requires the auditor to determine tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level. Auditing Standard No. 11 uses the term "tolerable misstatement," which is also used in other PCAOB standards.[18/] Appendix 10 discusses the use of the term "tolerable misstatement" in more detail.[19/]

IAASB and ASB

The ISA and SAS require the auditor to determine "performance materiality" for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures.

18/ Paragraph .18 of AU sec. 350, *Audit Sampling*.

19/ Section V.E. of Appendix 10.

4. Determining Tolerable Misstatement

PCAOB

Auditing Standard No. 11 contains a requirement to take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods when determining tolerable misstatement and planning and performing audit procedures. This requirement is adapted from AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*. Appendix 10 provides further discussion regarding this requirement.[20/]

IAASB and ASB

The ISA and SAS do not have an analogous requirement.

5. Multi-location Determination of Tolerable Misstatement

PCAOB

In multi-location engagements, Auditing Standard No. 11 requires the auditor to determine tolerable misstatement for the individual locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements. The standard also requires the tolerable misstatement at an individual location to be less than the established materiality level for the financial statements as a whole. Appendix 10 provides further discussion regarding consideration of materiality for multi-location engagements.[21/]

IAASB

ISA 600 requires the group engagement team to determine, among other things, component materiality. The ISA states:

> Component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit. To reduce to an appropriately low level the probability that the aggregate of

[20/] Ibid.

[21/] Section V.F. of Appendix 10.

> uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole, component materiality shall be lower than materiality for the group financial statements as a whole.

ASB

Proposed SAS, *Audits of Group Financial Statements (Including the Work of Component Auditors)*, requires the group engagement team to determine among other things, component materiality. The proposed SAS states:

> Component materiality for those components on which an audit or other specified audit procedures will be performed. To reduce the risk that the aggregate of detected and undetected misstatements in the group financial statements exceeds the materiality for the group financial statements as a whole, component materiality should be lower than the materiality for the group financial statements as a whole.

6. Reevaluating Materiality and Tolerable Misstatement

PCAOB

Auditing Standard No. 11 requires the auditor to reevaluate the established materiality level or levels and tolerable misstatement when there is a substantial likelihood that misstatements of amounts that differ significantly from the materiality level or levels that were established initially would influence the judgment of a reasonable investor. The requirement reflects the perspective of a reasonable investor, whereas the analogous requirements in the ISA and SAS reflect an auditor's perspective. Appendix 10 provides additional discussion regarding materiality from the perspective of a reasonable investor[22/] and the reevaluation of materiality.[23/]

IAASB and ASB

The ISA and the SAS require the auditor to "revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances, or disclosures) in the event of becoming

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22/ Section V.B. of Appendix 10.

23/ Section V.G. of Appendix 10.

aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially."

Auditing Standard No. 12 – Identifying and Assessing Risks of Material Misstatement

In this section, the analogous IAASB standards are ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment,* and ISA 240, *The Auditor's Responsibilities Relating to Fraud In An Audit of Financial Statements* (collectively referred to in this section as "the ISAs"). The analogous ASB standards are the clarified SAS, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatements* (Redrafted) and proposed SAS, *Consideration of Fraud in a Financial Statement Audit* (Redrafted) (collectively referred to in this section as "the SASs").[24/]

1. Objective

PCAOB

The objective of Auditing Standard No. 12 is to identify and appropriately assess the risks of material misstatement, thereby providing a basis for designing and implementing responses to the risks of material misstatement. Auditing Standard No. 12 requires the auditor to perform other risk assessment procedures in addition to obtaining an understanding of the company and its environment. Appendix 10 provides additional discussion regarding the objective of the standard.[25/]

IAASB and ASB

The ISAs state:

> The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control,

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[24/] In June 2010, the ASB adopted as a final standard the SAS, *Consideration of Fraud in a Financial Statement Audit (Redrafted).* However, the ASB has not yet published this standard.

[25/] Section VI.B. of Appendix 10.

> thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

The SASs include an objective similar to the ISAs' objective.

2. Performing Risk Assessment Procedures

PCAOB

Auditing Standard No. 12 states that the auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud, and designing further audit procedures. The requirement establishes a principle for determining the sufficiency of the necessary risk assessment procedures, and it also links the risk assessment procedures to the design of the tests of controls and substantive procedures to be performed to respond to the risks. Appendix 10 provides additional discussion regarding performing risk assessment procedures.[26/]

IAASB and ASB

The ISAs state:

> The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

The SASs include a requirement similar to the ISAs' requirement.

3. Obtaining an Understanding of the Company and Its Environment

PCAOB

Auditing Standard No. 12 includes a requirement to evaluate, while obtaining an understanding of the company, whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks

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26/ Section VI.C. of Appendix 10.

of material misstatement. Appendix 10 provides additional discussion regarding obtaining an understanding of the company and its environment.[27/]

IAASB and ASB

The ISAs and SASs do not include an analogous requirement.

4. Additional Procedures to Understand the Company

PCAOB

Auditing Standard No. 12 requires the auditor to consider performing certain procedures as part of obtaining an understanding of the company as required by paragraph 7 of the standard. These procedures include reading public information about the company, observing or reading transcripts of earnings calls, obtaining an understanding of compensation arrangements with senior management, and obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders. Appendix 10 provides additional discussion regarding this requirement.[28/]

IAASB and ASB

The ISAs and SASs do not include an analogous requirement.

5. Selection and Application of Accounting Principles, Including Related Disclosures

PCAOB

Auditing Standard No. 12 requires the auditor to develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework to identify and assess the risks of material misstatement related to omitted, incomplete, or inaccurate disclosures.[29/] The standard also requires engagement team members to discuss how

[27/] Section VI.D. of Appendix 10.

[28/] Ibid.

[29/] Paragraph 12 of Auditing Standard No. 12.

fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures.[30] Additionally Auditing Standard No. 12 requires the auditor's evaluation of fraud risk factors to include how fraud could be perpetrated or concealed by presenting incomplete or inaccurate disclosures or by omitting disclosures that are necessary for the financial statements to be presented fairly in conformity with the applicable financial reporting framework.[31] Appendix 10 provides additional discussion regarding these requirements.[32]

IAASB and *ASB*

The ISAs and SASs do include analogous requirements regarding the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.

6. Obtaining an Understanding of Internal Control Over Financial Reporting

PCAOB

Auditing Standard No. 12 requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements; (b) assess the factors that affect the risks of material misstatement; and (c) design further auditor procedures. This requirement relates to the sufficiency of the required understanding of internal control over financial reporting. Appendix 10 provides additional discussion of this requirement.[33]

IAASB and ASB

The ISAs state:

> The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to

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[30] Paragraph 52 of Auditing Standard No. 12.

[31] Paragraph 67 of Auditing Standard No. 12.

[32] Section VI.D, H, and J respectively of Appendix 10.

[33] Section VI.E. of Appendix 10.

financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

The SASs include requirements similar to the ISAs' requirements.

7. Control Environment

PCAOB

Auditing Standard No. 12 requires the auditor to assess the following matters as part of obtaining an understanding of the control environment:

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

This requirement is aligned with a similar requirement in Auditing Standard No. 5. Appendix 10 provides additional discussion regarding this requirement.[34/]

Paragraph 25 of Auditing Standard No. 12 states that "[i]f the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor." Appendix 10 provides additional discussion regarding the auditor's evaluation of an identified control deficiency in the control environment.[35/]

34/ Section VI.E.2. of Appendix 10.

35/ Ibid.

IAASB and ASB

The ISAs state:

> The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
>
> (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
>
> (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment.

The SASs include requirements similar to the ISAs' requirements.

The ISAs and SASs do not have a requirement analogous to paragraph 25 of Auditing Standard No. 12.

8. The Company's Risk Assessment Process

PCAOB

Auditing Standard No. 12 states that:

> The auditor should obtain an understanding of management's process for:
>
> (a) Identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud ("fraud risks"),
>
> (b) Assessing the likelihood and significance of misstatements resulting from those risks, and
>
> (c) Deciding about actions to address those risks.
>
> The standard also states that obtaining an understanding of the company's risk assessment process includes obtaining an understanding

> of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.

Those requirements focus on the matters that are important to the auditor's understanding of the company's internal control and on the auditor's risk assessments. Although the auditor can be informed by the company's risk assessment process, the auditor is still required to perform risk assessment procedures that are sufficient for identifying and assessing the risks of material misstatement rather than relying on the company's process.

Appendix 10 provides additional discussion regarding the company's risk assessment process.[36/]

IAASB and ASB

The ISAs state:

> The auditor shall obtain an understanding of whether the entity has a process for (a) Identifying business risks relevant to financial reporting objectives; (b) Estimating the significance of the risks; (c) Assessing the likelihood of their occurrence; and (d) Deciding about actions to address those risks.
>
> If the entity has established such a process (referred to hereafter as the "entity's risk assessment process"), the auditor shall obtain an understanding of it, and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process.
>
> If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been

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[36/] Section VI.E.3. of Appendix 10.

identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control.

The SASs include requirements similar to the ISAs' requirements.

9. Information and Communication

PCAOB

Auditing Standard No. 12 requires the auditor to obtain an understanding of how IT affects the company's flow of transactions. The standard also states that the identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the approach used to identify significant accounts and disclosures and their relevant assertions and, when applicable, to select the controls to test, as well as to assess risk and allocate audit effort. Appendix 10 provides additional discussion of this requirement.[37/]

IAASB and *ASB*

The ISAs and SASs do not include analogous requirements.

[37/] Section VI.E.4. of Appendix 10.

10. Control Activities

PCAOB

Auditing Standard No. 12 requires the auditor to obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures. Auditing Standard No. 12 requires the auditor to use his or her knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control over financial reporting in determining the extent to which it is necessary to devote additional attention to obtaining an understanding of control activities to assess the factors that affect the risks of material misstatement and to design further audit procedures. Appendix 10 provides additional discussion of this requirement.[38/]

IAASB

The ISAs state:

> The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them.

ASB

The SASs state:

> The auditor should obtain an understanding of control activities relevant to the audit, which are those control activities the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in

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[38/] Section VI.E.5. of Appendix 10.

the financial statements or to every assertion relevant to them. However, the auditor should obtain an understanding of the process of reconciling detailed records to the general ledger for material account balances.

11. Relationship of Understanding of Internal Control to Tests of Controls

PCAOB

Auditing Standard No. 12 requires the auditor to take into account the evidence obtained from understanding internal control when assessing control risk and, in the audit of internal control, forming conclusions about the effectiveness of controls. Auditing Standard No. 12 also requires the auditor to take into account the evidence obtained from understanding internal control when determining the nature, timing, and extent of procedures necessary to support the auditor's conclusions about the effectiveness of entity-level controls in the audit of internal control. Appendix 10 provides additional discussion of these requirements.[39/]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

12. Considering Information from the Client Acceptance and Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements

PCAOB

Auditing Standard No. 12 requires the auditor to evaluate whether information obtained during a review of interim financial information in accordance with AU sec. 722, *Interim Financial Information,* is relevant to identifying risks of material misstatement in the year-end audit. The ISAs and SASs do not include an analogous requirement.

Auditing Standard No. 12 also states that the auditor should obtain an understanding of the nature of the services that have been performed for the company by the auditor or affiliates of the firm[40/] and should take into account relevant information

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[39/] Section VI.E.7. of Appendix 10.

[40/] PCAOB Rule 3501, *Definitions of Terms Employed in Section 3, Part 5 of the Rules*.

obtained from those engagements in identifying risks of material misstatement. The requirement in Auditing Standard No. 12 applies to services performed by the firm and affiliates of the firm and is not limited to services performed by the engagement partner. Appendix 10 provides additional discussion regarding these requirements.[41/]

IAASB and *ASB*

The ISAs state, "[i]f the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement."

The SASs include a requirement similar to the ISAs' requirement.

13. Performing Analytical Procedures

PCAOB

Auditing Standard No. 12 contains a series of requirements regarding performing analytical procedures as risk assessment procedures. These requirements were adapted from AU sec. 329, *Analytical Procedures*. Auditing Standard No. 12 requires the auditor to:

- Perform analytical procedures that are designed to (a) enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior year end; and (b) identify areas that might represent specific risks relevant to the audit, including the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.

- Perform analytical procedures regarding revenue as risk assessment procedures with the objective of identifying unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud.

- Take into account analytical procedures performed in accordance with AU sec. 722 when designing and applying analytical procedures as risk assessment procedures. This requirement is unique to PCAOB standards.

[41/] Section VI.F.2. of Appendix 10.

- Use his or her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure.[42/]

- Take into account unusual or unexpected differences from the auditor's expectations that are identified while performing analytical procedures as risk assessment procedures.

Appendix 10 provides additional discussion of these requirements.[43/]

IAASB

The ISAs state:

> The risk assessment procedures shall include...[a]nalytical procedures…
>
> The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

ASB

The SASs state:

> The risk assessment procedures should include...[a]nalytical procedures…
>
> Based on analytical procedures performed as part of risk assessment procedures and as part of substantive procedures, the auditor should evaluate whether unusual or unexpected relationships that have been identified indicate risks of material misstatements due to fraud. To the extent not already included, the

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42/ Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

43/ Section VI.G. of Appendix 10.

analytical procedures and evaluation thereof should include procedures relating to revenue accounts.

14. Communication among Engagement Team Members

PCAOB

Auditing Standard No. 12 requires that the communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change. Appendix 10 provides additional discussion of this requirement.[44/]

IAASB and *ASB*

The ISAs and SASs do not include analogous requirements.

15. Discussion of the Potential for Material Misstatement Due to Fraud

PCAOB

Auditing Standard No. 12 requires a discussion among the key engagement team members of specified matters regarding fraud, including how and where the company's financial statements might be susceptible to material misstatement due to fraud, known fraud risk factors, the risk of management override of controls, and possible responses to fraud risks.

Auditing Standard No. 12 requires all key engagement team members to participate in the discussion. Auditing Standard No. 12 also states that key engagement team members include the engagement partner and other engagement team members with significant engagement responsibilities.

Auditing Standard No. 12 also includes a requirement to emphasize certain matters to all engagement team members, including the need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, to be alert for information or other conditions that might affect the assessment of fraud risks, and actions to be taken if information or other conditions indicate that a material misstatement due to fraud might have occurred.

44/ Section VI.H.2. of Appendix 10.

Appendix 10 provides additional discussion of these requirements.[45/]

IAASB

The ISAs state:

> The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion.
>
> …This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.

ASB

The SASs have requirements similar to the ISAs' requirements. However, the SASs also include a requirement that the discussion regarding fraud include an exchange among engagement team members about how and where the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. The SASs also include a requirement to emphasize certain matters to all engagement team members, but those matters identified are less extensive than those required by PCAOB standards.

45/ Section VI.H. of Appendix 10.

16. Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

PCAOB

Auditing Standard No. 12 requires the auditor to make specified inquiries of management and the audit committee regarding tips or complaints about the company's financial reporting. Appendix 10 provides additional discussion of this requirement.[46/]

IAASB and ASB

The ISAs and the SASs do not specify the nature of the required inquiries, except for certain inquiries regarding fraud, which are less extensive than those required by PCAOB standards.

17. Nature of Inquiries

PCAOB

Auditing Standard No. 12 requires the auditor to use his or her knowledge of the company and its environment, as well as information from other risk assessment procedures, to determine the nature of inquiries about risks of material misstatement. Appendix 10 provides additional discussion of this requirement.[47/]

IAASB and *ASB*

The ISAs and SASs do not include analogous requirements.

18. Evaluating Management Responses to Inquiries

PCAOB

Auditing Standard No. 12 requires the auditor to take into account the fact that management is often in the best position to commit fraud when evaluating management's responses to inquiries about fraud risks. Auditing Standard No. 12 also

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[46/] Section VI.I. of Appendix 10.

[47/] Ibid.

requires the auditor to obtain evidence to address inconsistencies in response to the inquiries. Appendix 10 provides additional discussion of these requirements.[48/]

IAASB and *ASB*

The ISAs and SASs do not include analogous requirements.

19. Identifying and Assessing the Risks of Material Misstatement

PCAOB

Auditing Standard No. 12 requires the auditor to evaluate how risks at the financial statement level could affect risks of material misstatement at the assertion level. Appendix 10 provides additional discussion of this requirement.[49/]

IAASB and ASB

The ISAs and the proposed SAS do not include an analogous requirement.

20. Identifying Significant Accounts and Disclosures and Their Relevant Assertions

PCAOB

Auditing Standard No. 12 requires the auditor to identify significant accounts and disclosures and their relevant assertions in identifying and assessing risks of material misstatement. PCAOB standards require auditors to perform substantive procedures for relevant assertions of significant accounts and disclosures in the audit of financial statements and tests of controls over relevant assertions of significant accounts and disclosures in the audit of internal control. Appendix 10 provides additional discussion regarding identifying significant accounts and disclosures and relevant assertions.[50/]

48/ Ibid.

49/ Section VI.J. of Appendix 10.

50/ Ibid.

IAASB and *ASB*

The ISAs and SASs do not have an analogous requirement.

21. Significant Risks

PCAOB

Auditing Standard No. 12 defines significant risk as a "risk of material misstatement that requires special audit consideration." This definition is different from the ISAs' definition because it omits two qualifying phrases, "an identified and assessed" and "in the auditor's judgment." Appendix 10 provides additional discussion regarding the definition of significant risks.[51/]

IAASB and ASB

The ISAs and SASs define significant risk as "an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration."

Auditing Standard No. 13 – The Auditor's Responses to the Risks of Material Misstatement

In this section, the analogous IAASB standards are ISA 330, *The Auditor's Responses to Assessed Risks*, and ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* (collectively referred to in this section as "the ISAs"). The analogous ASB standards are the clarified SAS, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted), and the proposed SAS, *Consideration of Fraud in a Financial Statement Audit* (Redrafted) (collectively referred to in this section as "the SASs").

1. Objective

PCAOB

The objective of the auditor in Auditing Standard No. 13 is "to address the risks of material misstatement through appropriate overall audit responses and audit procedures." The objective in the proposed standard emphasizes the auditor's

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51/ Section VI.K. of Appendix 10.

responsibility for responding to the risks of material misstatements. Appendix 10 provides additional discussion regarding the objective of the standard.[52/]

IAASB and ASB

The objective in the ISAs and the SASs is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

2. Overall Responses to Risks

PCAOB

Auditing Standard No. 13 requires the auditor to design and implement certain overall responses (e.g., making appropriate assignments of specific engagement responsibilities, providing an appropriate extent of supervision, incorporating elements of unpredictability in selecting auditing procedures, and evaluating the company's selection and application of significant accounting principles) to address risks of material misstatement. These responses are not limited to addressing risks at the financial statement level. They are also intended to address risks at the significant account or disclosure level due to the nature of these specific overall responses. Appendix 10 provides additional discussion of this requirement.[53/]

IAASB and ASB

The ISAs and the SASs include requirements to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level and requirements for particular types of responses to the risks of material misstatement due to fraud at the financial statement level.

3. Determination of the Need for Pervasive Changes

PCAOB

Auditing Standard No. 13 requires the auditor to determine whether it is necessary to make pervasive changes to the nature, timing, or extent of audit

52/ Section VII.B. of Appendix 10.

53/ Section VII.C. of Appendix 10.

procedures to adequately address the assessed risk of material misstatement. Examples of such pervasive changes include modifying the audit strategy to increase the substantive testing of the valuation of numerous significant accounts at year end because of significantly deteriorating market conditions and to obtain more pervasive audit evidence from substantive procedures due to the identification of pervasive weaknesses in the company's control environment. Appendix 10 provides detailed discussions regarding making pervasive changes as an overall response to risks of material misstatement.[54/]

IAASB and *ASB*

The ISAs and SASs do not include analogous requirements.

4. Application of Professional Skepticism

PCAOB

Auditing Standard No. 13 states that due professional care requires the auditor to exercise professional skepticism, requires that the auditor apply professional skepticism in gathering and evaluating audit evidence in response to risks of material misstatement, and provides examples of the appropriate application of professional skepticism. Appendix 10 provides additional discussion regarding application of professional skepticism.[55/]

IAASB and ASB

The ISAs state

> …the auditor shall maintain an attitude of professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.

The SASs include a requirement similar to the ISAs' requirement.

54/ Ibid.

55/ Ibid.

5. Evidence about the Effectiveness of Controls

PCAOB

In discussing testing controls in an audit of financial statements, Auditing Standard No. 13 establishes the principle that the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The greater the reliance on a control, the more persuasive evidence the auditor is required to obtain from the tests of controls.

In addition, the standard requires the auditor to obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls. Appendix 10 provides additional discussions of these requirements.[56/]

IAASB and ASB

The ISAs and the SASs include a requirement for the auditor to obtain more persuasive audit evidence the greater the reliance he or she plans to place on the effectiveness of a control, but they do not have an analogous requirement regarding situations in which the audit approach consists primarily of tests of controls.

6. Testing the Operating Effectiveness of a Control

PCAOB

Auditing Standard No. 13 requires the auditor to determine whether the control selected for testing is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. The standard also discusses the procedures the auditor performs in testing operating effectiveness. To help facilitate the tests of controls in an integrated audit, the standard continues to use language similar to that of Auditing Standard No. 5 when describing analogous terms and concepts relating to the testing of controls. Appendix 10 provides additional discussion regarding this requirement.[57/]

56/ Section VII.F.3. of Appendix 10.

57/ Section VII.F.4. of Appendix 10.

IAASB

The ISAs do not include an analogous requirement to determine whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

ASB

The SASs state:

> In designing and performing tests of controls, the auditor should:
>
> *a.* perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including …by whom or by what means they were applied, including, when applicable, whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

7. Tests of Controls in an Integrated Audit

PCAOB

Auditing Standard No. 13 requires the auditor to perform tests of controls in integrated audits to meet the objectives of both the audit of financial statements and the audit of internal control. Appendix 10 provides additional discussion of this requirement.[58/]

IAASB and ASB

The ISAs and the SASs do not include an analogous requirement.

[58/] Section VII.D. of Appendix 10.

8. Rotational Testing of Controls

PCAOB

Auditing Standard No. 13 requires the auditor to obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies. Appendix 10 provides additional discussion of this requirement.[59/]

IAASB and ASB

The ISAs and the SASs include requirements that apply to the use of evidence about controls obtained in prior audits and allow rotational testing of controls under certain conditions set forth in those standards.

9. Assessing Control Risk

PCAOB

Auditing Standard No. 13 requires the auditor to assess control risk for relevant assertions by evaluating the evidence from all sources, including the auditor's testing of controls for the audit of internal control and the audit of financial statements, misstatements detected during the financial statement audit, and any identified control deficiencies. The standard also requires that control risk be assessed at the maximum level for relevant assertions (1) for which controls necessary to sufficiently address the assessed risk of material misstatement in those assertions are missing or ineffective or (2) when the auditor has not obtained sufficient appropriate audit evidence to support a control risk assessment below the maximum level. Appendix 10 provides additional discussion of these requirements.[60/]

IAASB and ASB

The ISAs and the SASs include requirements regarding evaluating the operating effectiveness of controls and identified control deviations, but those standards do not require a specific assessment of control risk.

59/ Section VII.F.6. of Appendix 10.

60/ Section VII.F.7. of Appendix 10.

10. Substantive Procedures

PCAOB

Auditing Standard No. 13 requires the auditor to perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk. This requirement reflects the principle that the auditor needs to implement appropriate responses to address assessed risks of material misstatement. Appendix 10 provides additional discussion of this requirement.[61/]

IAASB

The ISAs state, "Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure."

ASB

The SASs state, "Irrespective of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure."

The requirements in the ISAs and the SASs focus on the accounts and disclosures that are material, regardless of whether they are associated with identified risks of material misstatement.

11. Consideration of Confirmations

PCAOB

Auditing Standard No. 13 requires the auditor to perform substantive procedures for each relevant assertion of each significant account and disclosure. The standard also discusses how to determine the types and combination of substantive audit procedures necessary to detect material misstatements in relevant assertions.

AU sec. 330, *The Confirmation Process*, establishes requirements regarding the use of confirmation procedures.[62/] The risk assessment standards discuss the auditor's

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61/ Section VII.G. of Appendix 10.

62/ The Board has a separate standards-setting project on confirmations.

responsibilities for designing and performing the substantive procedures necessary to address the risks of material misstatement.

IAASB and ASB

ISA 330 specifically requires the auditor to consider whether external confirmation procedures are to be performed as substantive audit procedures. The ASB has proposed to amend the SASs to require the auditor to consider whether external confirmation procedures are to be performed as substantive audit procedures and to require the use of external confirmation procedures for material accounts receivable.

12. Determining Whether to Perform Interim Substantive Procedures

PCAOB

Auditing Standard No. 13 requires the auditor to take into account a series of factors when determining whether it is appropriate to perform substantive procedures at an interim date. Appendix 10 provides additional discussion regarding timing of substantive procedures.[63/]

IAASB and ASB

The ISAs and the SASs do not include an analogous requirement for the auditor to take into account the factors listed in Auditing Standard No. 13 when determining whether it is appropriate to perform substantive procedures at an interim date.

13. Substantive Procedures Covering the Remaining Period

PCAOB

Auditing Standard No. 13 states, "When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end." The standard contains a specific requirement to compare relevant information about the account balance at the interim date with comparable information at the end of

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[63/] Section VII.H. of Appendix 10.

the period to identify amounts that appear unusual. Appendix 10 provides additional discussion of this requirement.[64/]

IAASB and ASB

The ISAs and the SASs include requirements to cover the period between the interim testing date and year end by performing substantive procedures, combined with tests of controls for the intervening period, or by performing further substantive procedures only if the auditor determines that doing so would be sufficient. The ISAs and SASs do not include an analogous requirement regarding the specific procedures to be performed.

14. Response to Significant Risks

PCAOB

Auditing Standard No. 13 requires the auditor to perform substantive procedures, including tests of details, that are specifically responsive to significant risks. Appendix 10 provides additional discussion of this requirement.[65/]

IAASB and ASB

The ISAs state:

> If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

The SASs include requirements similar the ISAs' requirements.

64/ Ibid.

65/ Section VII.I. of Appendix 10.

15. Dual-purpose Tests

PCAOB

Auditing Standard No. 13 states that, when dual-purpose tests are performed, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested. Appendix 10 provides additional discussion of this requirement.[66/]

IAASB and ASB

The ISAs and the SASs do not include analogous requirements.

Auditing Standard No. 14 – Evaluating Audit Results

In this section, the analogous IAASB standards are ISA 450, *Evaluation of Misstatements Identified During the Audit,* ISA 330, *The Auditor's Responses to Assessed Risks,* ISA 520, *Analytical Procedures,* ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements,* ISA 540, *Auditing Accounting Estimates Including Fair Value Accounting Estimates, and Related Disclosures,* and ISA 700, *Forming an Opinion and Reporting on Financial Statements* (collectively referred to in this section as "the ISAs"). The analogous ASB standards are clarified SAS *Evaluation of Misstatements Identified During the Audit, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (Redrafted), Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement (Redrafted),* and proposed SAS *Consideration of Fraud in a Financial Statement Audit (Redrafted), Analytical Procedures (Redrafted),* and *Forming an Opinion and Reporting on Financial Statements* (collectively referred to in this section as "the SASs").

1. Performing Analytical Procedures in the Overall Review

PCAOB

In the overall review, Auditing Standard No. 14 contains specific requirements for the auditor to read the financial statements and disclosures and perform analytical

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[66/] Section VII.J. of Appendix 10.

procedures to (a) evaluate the auditor's conclusions formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement. These requirements were adapted from existing requirements in PCAOB standards.[67/] The conclusions formed from the results of the overall review of the audit are intended to inform the auditor's conclusions regarding significant accounts and disclosures and the opinion on the financial statements. Appendix 10 provides additional discussion of these requirements.[68/]

IAASB

The ISAs state:

> The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

ASB

The SASs state:

> The auditor should design and perform analytical procedures near the end of the audit that are intended to corroborate audit evidence obtained during the audit of financial statements to assist the auditor in drawing reasonable conclusions on which to base the auditor's opinion.

2. Evaluating Evidence from Analytical Procedures

PCAOB

Auditing Standard No. 14 contains a requirement, which was adapted from an existing requirement in PCAOB standards,[69/] for the auditor, as part of the overall review

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[67/] AU sec. 329.23.

[68/] Section VIII.C. of Appendix 10.

[69/] AU sec. 329.23.

to evaluate whether (a) the evidence gathered in response to unusual or unexpected transactions, events, amounts or relationships previously identified during the audit is sufficient and (b) unusual or unexpected transactions, events, amounts, or relationships indicate risks of material misstatement that were not identified previously, including, in particular, fraud risks. Auditing Standard No. 14 also specifically requires the auditor to evaluate whether the evidence gathered during the audit is sufficient as part of the overall review.

Also, the requirements in Auditing Standard No. 14 relate to risks of material misstatement due to error or fraud, whereas the requirements in the ISAs and SASs are limited to fraud risks. Appendix 10 provides additional discussion of these requirements in Auditing Standard No. 14.[70/]

IAASB

The ISAs state:

> The auditor shall evaluate whether analytical procedures that are performed near the end of the audit, when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment, indicate a previously unrecognized risk of material misstatement due to fraud.

ASB

The SASs state:

> The auditor should evaluate whether the accumulated results of auditing procedures, including analytical procedures, that are performed during the audit, in the overall review stage, or in both stages, when forming an overall conclusion concerning whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment, indicate a previously unrecognized risk of material misstatement due to fraud.

70/ Section VIII.C. of Appendix 10.

3. Analytical Procedures Regarding Revenue

PCAOB

Auditing Standard No. 14 includes a requirement, adapted from an existing requirement in AU sec. 316, for the auditor to perform analytical procedures relating to revenue through the end of the period. These procedures are intended to identify unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud. Appendix 10 provides additional discussion of this requirement.[71/]

IAASB

The ISAs state:

> The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

The ISAs do not specifically require the auditor to perform analytical procedures related to revenue through the end of the period.

ASB

The SASs require the auditor to perform analytical procedures related to revenue.

4. Corroborating Management Explanations

PCAOB

Auditing Standard No. 14 requires the auditor to corroborate management's explanations regarding significant unusual or unexpected transactions, events, amounts, or relationships. Auditing Standard No. 14 also states that if management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures to address the matter. Unlike the ISAs, Auditing Standard No. 14 specifically requires the auditor to corroborate management's explanations regarding significant

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[71/] Ibid.

matters. Appendix 10 provides additional discussion regarding corroborating management's explanations.[72/]

IAASB and ASB

The ISAs and the SASs require the auditor to investigate the identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount by (a) inquiring of management and obtaining appropriate audit evidence relevant to management's responses and (b) performing other audit procedures as necessary in the circumstances. The ISAs and the SASs also include a requirement to investigate inconsistent responses to inquiries from management and those charged with governance.

5. Communication of Accumulated Misstatements

PCAOB

Auditing Standard No. 14 requires the auditor to communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them. Unlike the ISAs and the SASs, Auditing Standard No. 14 does not require the auditor to request management to correct the misstatements. Instead, PCAOB standards focus on communicating the misstatements to management, performing procedures to determine whether management corrected them, understanding the reasons why management might not have corrected the misstatements, and evaluating the effect of uncorrected misstatements on the financial statements and the audit. Appendix 10 provides additional discussion of this requirement.[73/]

IAASB and *ASB*

The ISAs and the SASs include requirements to communicate on a timely basis all misstatements accumulated during the audit to an appropriate level of management and to request that management correct those misstatements.

[72/] Ibid.

[73/] Section VIII.J. of Appendix 10.

6. Correction of Misstatements

PCAOB

Auditing Standard No. 14 requires that if management has made corrections to accounts or disclosures in response to misstatements detected by the auditor, the auditor should evaluate management's work to determine whether the corrections have been appropriately recorded and determine whether uncorrected misstatements remain. Appendix 10 provides additional discussion of this requirement.[74/]

IAASB and *ASB*

The ISAs and the SASs contain a requirement to perform additional audit procedures to determine whether misstatements remain, if at the auditor's request management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected.

The ISAs do not require the auditor to evaluate whether the misstatements that were communicated by the auditor to management have been appropriately corrected by management.

7. Evaluating Misstatements – Effect on Risk Assessments

PCAOB

Auditing Standard No. 14 contains a requirement to evaluate the nature and the effects of individual misstatements accumulated during the audit on the assessed risks of material misstatement in determining whether the risk assessments remain appropriate. Appendix 10 provides additional discussion of this requirement.[75/]

IAASB and *ASB*

The ISAs and the SASs do not include an analogous requirement.

74/ Section VIII.F. of Appendix 10.

75/ Section VIII.I. of Appendix 10.

8. Evaluating Whether Misstatements Might Be Indicative of Fraud

PCAOB

Auditing Standard No. 14 requires the auditor to perform procedures to obtain additional audit evidence to determine whether fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report if the auditor believes that a misstatement is or might be intentional, and if the effect on the financial statement cannot be readily determined. Appendix 10 provides additional discussions of this requirement.[76/]

IAASB and *ASB*

The ISAs require the auditor to evaluate the implications for the audit if the auditor confirms that or is unable to conclude whether financial statements are materially misstated as a result of fraud. The ISA does not explicitly require the auditor to perform audit procedures to obtain additional audit evidence to determine the effect of the misstatement on the financial statements.

The SASs include a requirement similar to the ISAs' requirement.

9. Communications Regarding Fraud

PCAOB

Auditing Standard No. 14 requires the auditor to determine his or her responsibility under AU secs. 316.79-.82A, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j-1, if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred. AU sec. 316 requires that whenever the auditor has determined that there is evidence that fraud may exist, the auditor should bring that matter to the attention of an appropriate level of management.[77/] Appendix 10 provides additional discussion of this requirement.[78/]

[76/] Ibid.

[77/] AU sec. 316.79.

[78/] Section VIII.K. of Appendix 10.

IAASB and ASB

The ISAs state that if the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management.

The SASs include a requirement similar to the ISAs' requirement.

10. Evaluating the Qualitative Aspects of the Company's Accounting Practices

PCAOB

Auditing Standard No. 14 states that if the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. The standard also contains a requirement for the auditor to evaluate whether the auditor's risk assessments, including the assessment of fraud risks, and the related responses remain appropriate. Appendix 10 provides additional discussion of these requirements.[79/]

IAASB and ASB

The ISAs and the SASs contain a requirement for the auditor to evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

11. Management's Identification of Offsetting Adjusting Entries

PCAOB

If management identifies adjusting entries that offset misstatements accumulated by the auditor, Auditing Standard No. 14 requires the auditor to perform procedures to determine why the misstatements were not identified previously and to evaluate the implications on the integrity of management and the auditor's risk assessments, including fraud risk assessments. Auditing Standard No. 14 also requires the auditor to

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[79/] Section VIII.L. of Appendix 10.

perform additional procedures as necessary to address the risk of further undetected misstatements. Appendix 10 provides additional discussion of these requirements.[80/]

IAASB and *ASB*

The ISAs and SASs do not include analogous requirements.

12. Evaluating Conditions Relating to Assessment of Fraud Risks

PCAOB

Auditing Standard No. 14 requires the engagement partner to determine whether there has been appropriate communication with other engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks. Appendix 10 provides additional discussion of this requirement.[81/]

IAASB

The ISAs require a discussion among the engagement team members and a determination by the engagement partner of matters to be communicated to those team members not involved in the discussion.

ASB

The SASs contain a requirement for the engagement partner to ascertain that appropriate communication exists about the need for the discussion of fraud risks among team members throughout the audit.

Auditing Standard No. 15 – Audit Evidence

In this section, the analogous IAASB and ASB standards are ISA 500, *Audit Evidence,* and the clarified SAS, *Audit Evidence (Redrafted)*, respectively.

80/ Ibid.

81/ Section VIII.M. of Appendix 10.

1. Objective and Overarching Requirement

PCAOB

The objective of the auditor in Auditing Standard No. 15 is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report. The objective of the standard, together with the related requirement regarding audit evidence, articulates the linkage between the auditor's responsibility to obtain sufficient appropriate audit evidence and to support his or her opinion. Appendix 10 provides additional discussion regarding the objective of the standard.[82/]

IAASB and ASB

The ISA states:

> The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

The ISA also states:

> The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

The SAS includes an objective and a requirement similar to the ISA's objective and requirement.

2. Document Authentication

PCAOB

Auditing Standard No. 15 states that the auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor is required to modify the planned

[82/] Section IX.C. of Appendix 10.

audit procedures or perform additional audit procedures to respond to those conditions and to evaluate the effect, if any, on the other aspects of the audit. Auditing Standard No. 15 omits protective language, such as "[u]nless the auditor has reason to believe the contrary, the auditor may accept records and document as genuine" that would weaken the requirement. Appendix 10 provides additional discussion regarding this requirement.[83/]

IAASB and ASB

The ISA states:

> Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further.

The SAS includes a requirement similar to the ISA's requirement.

3. Selecting Items for Testing to Obtain Audit Evidence

PCAOB

Auditing Standard No. 15 states that the auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. This requirement links the selection of items for testing to the sufficiency of the audit evidence. Appendix 10 provides additional discussion of this requirement.[84/]

[83/] Section IX.E. of Appendix 10

[84/] Section IX.J. of Appendix 10.

IAASB and ASB

The ISA states:

> When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure.

The SAS includes a requirement similar to the ISA's requirement.